

Office of
Tax Simplification

**The closer alignment of income tax
and national insurance**

March 2016

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ISBN 978-1-910835-25-8

PU1909

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Foreword

Is closer alignment of Income Tax and National Insurance a realistic idea?

This is the question the Office of Tax Simplification (OTS) has been exploring, as bringing Income Tax and National Insurance (NICs) together has long been sought by individuals and businesses.

In contributing to this review, employers who administer the system expressed many concerns, particularly about the administrative complexity of applying different sets of rules; individuals were unclear on the relationship between NICs and benefit entitlement; and there was little recognition of the differing and sometimes distorted outcomes for the employee and the self-employed. In earlier reviews, the OTS has flagged these issues and in this review recommends that the time is now right to consider in detail the case for change.

The main sources of complexity are the fundamental differences between the two taxes and it became clear during the review that this complexity is invariably brought about by NICs.

This review therefore addresses the question of simplification from the perspective of reforming NICs through aligning its operation more closely to income tax. It sets out where and how to start this process, and is not about a merger of the two systems. The OTS has sought to surface the many differences between the two systems, how these could be addressed and to highlight groups who could be adversely impacted by any change.

Alignment inevitably will result in gainers and losers for employees and employers and further work is required to drill down through the high level statistics to establish the true situation. Then there are 4.7 million self-employed individuals and, for those who pay NICs, aligning with income tax may well result in some paying more although they may receive a greater range of welfare benefits too. A similar situation arises for the individual who has more than one job but whose jobs pay less than the NICs threshold. The numbers in this group are not small – an estimated 2.6 million people have more than one concurrent job. In addition, the review found other anomalous situations – not surprising when considering the myriad of differences between income tax and NICs. Alignment is not a straightforward process.

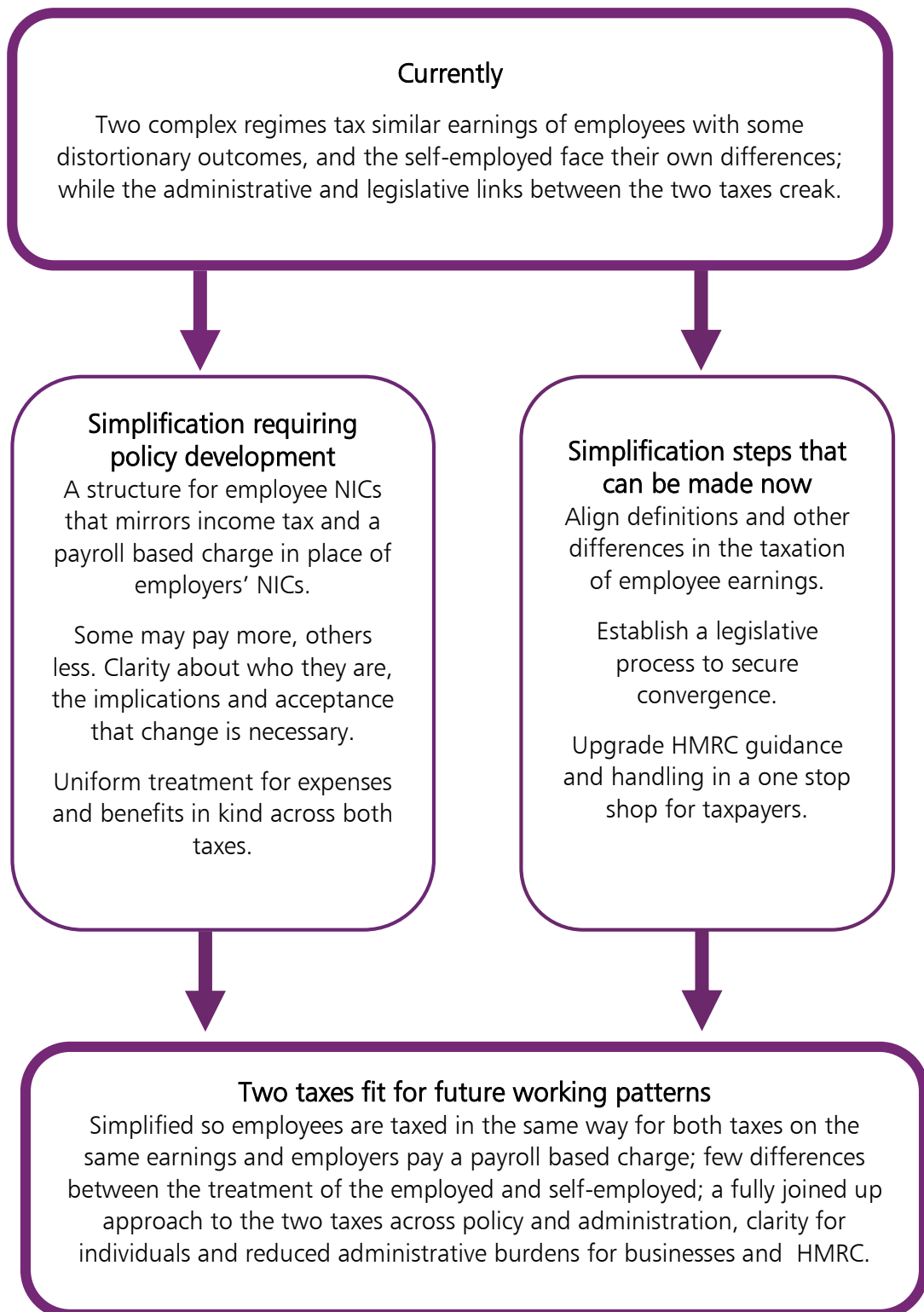
It is often the case that with any proposed change, the focus is on the winners with the result that many a proposal has run into the sands by failing to consider openly at the start those groups for whom there are downsides. The OTS does not intend that to happen here: we want a full debate on the issues in the context of the right process and timetable.

Meanwhile the structure of the economy is moving rapidly towards scenarios where many more people are 'multi-jobbers', have zero hours contracts, are self-employed or contracting out their services using new and often disruptive technologies. Whether referred to as 'uberisation', the 'sharing economy' or the 'gig economy', these ways of working are expected to accelerate, and require modernisation of income tax and NICs administration as a priority.

By highlighting the need for change and shining a light on the difficult areas now, the OTS intends not just to inform, but to use this review to commence a full and informed debate on what changes are necessary, how they could be made and the timetable, the challenges for 'loser' groups and how we can make change as seamless and as fruitful as possible. We want that debate to lead to a system that is ready for the future.

Angela Knight, Chair, Office of Tax Simplification

Income Tax and National Insurance Alignment



...we think it is – and this is how we addressed the underlying questions

Bringing Income Tax and NICs closer together has been a recommendation of the Office of Tax Simplification (OTS) on a number of occasions already. Differences between the two taxes¹ were identified as one of the top causes of complexity for small businesses in one of our first reports; more recently our Competitiveness and Employment Status reports have returned to the theme.

This project's aim has been to take it as read that closer alignment (importantly not combination – that is a step too far at this stage) is a Good Idea. However, we do not underestimate the difficulties involved in making progress in this area (unlike, perhaps, some of those who call for immediate merger). We have been looking for the problems and the possibilities, the gainers and losers, the legislative and administrative implications, the transition and the long-term position, and lay all of these issues out for proper debate.

In setting the project rolling, I posed five broad questions

- Can we move to a common definition for Income Tax and NICs for earnings?
- What about moving NICs to an annual, aggregate and cumulative basis?
- Should the self-employed pay (and benefit) in the same way as the employed?
- Is the contributory principle still worth it?
- What of employers' NICs?

As our work has progressed, we added other questions such as

- What lessons can we draw from other countries?
- Why are benefits in kind treated differently for NICs?
- Can we improve the system for employees coming to and leaving the UK?
- Why can't NICs be changed in the Finance Bill?

Thus like Bob Dylan in his classic song 'Blowin' in the wind', we posed nine questions. We're very grateful for the enthusiastic support and interest we have had as we have tried to answer them, from so many stakeholders from so wide a canvas - businesses large and small, representative bodies, advisers paid and unpaid, unions, academics, charities, HMRC staff, our excellent Consultative Committee, plus the over 600 people who tackled our on-line surveys. All convinced us that we weren't just blowin' in the wind, even if unlike Dylan, we kept finding more questions.

We think we have gathered enough evidence, combined with our own researches, to arrive at answers to all of our questions. That said, we don't pretend to have got to complete answers. Although this is a stage 2 project rather than initial examination, we have not bottomed out everything to do with the possible changes. There is more work to do, for us and HMRC / HMT / DWP particularly around numbers of those impacted and what that impact would be. Aligning IT/NICs is complex, not least because many of the ways forward interact. There are elements that can be taken forward independently, or ahead of others, but this is a reform package.

¹ One decision we took early on in our project was to refer to NICs as a tax. We say more about this at the end of Chapter 8 but we suspect that most people will readily endorse this label, echoing what almost everyone in our meetings said. We were tempted to make a formal recommendation on the matter but it is probably a policy matter outside our scope. But we do think it is something that should be addressed properly and head-on.

The message that we want to give ministers is that there are reforms here that many want and which would make a real difference. They have the potential to deliver real simplification, greater transparency and greater understanding. They fit with (and take advantage of) the drive to digital and offer some admin savings. Above all there is a need for something of a NICs relaunch to help people gain a better understanding of what is going on.

It is not just ministers who will have to think about our findings. This report aims to bring the issues raised by 'closer alignment' into sharp focus for all of us. We want to make sure that there is a proper debate on the implications - for example, moving NICs to an annual / cumulative/aggregate basis receives very wide support, but some people will end up paying more NICs as a result (with some gaining entitlements to benefits). Is that what is wanted? Recasting employers' NICs as a payroll tax is seen as an obvious move by many – but it would have a mixed and complex impact on lower-paid jobs.

The OTS has been lucky to have had a great team working on the project - Marian Drew (as project leader), Elaine Kennedy, John Hampton, Justine Riccomini and Theresa Dendy. Grant Thornton and Deloitte have been very generous in making Elaine and Theresa respectively available to us. The team nominally work only two days a week each but the 'two' seems to have been only a starting point! Angela Brown joined us from HMRC after we were under way as project manager and has worked heroically to get us coordinated and managed to the finishing gate. HMRC's Knowledge, Analysis and Intelligence (KAI) team has as always given us valuable support. Although at times it has seemed a very large team (in OTS terms!), with ideas fizzing all over the place, the timescale of the project has meant we have between us put in only around a man year into the project.

Our report is in two halves

- the first section (Chapters 1 to 7) is a series of summaries and is preceded by a short executive summary
- the second section (Chapters 8 to 13) contains the fuller analysis and discussion of our findings and is supplemented by further annexes

I commend the report to you - I hope it is widely read and I hope it generates a lot of feedback to us and ministers as it is considered how to take it forward. The OTS thinks we are making recommendations that are very much blowin' with the wind.

John Whiting

Tax Director, Office of Tax Simplification

Executive summary

Background to the review

In his summer Budget 2015 the Chancellor of the Exchequer confirmed that the OTS would be conducting a review into the closer alignment of Income Tax (IT) and NICs. The Financial Secretary to the Treasury set out an ambition that the OTS would take a greater role in the public debate, challenge HMRC on its digital agenda, and tackle the big complexities in the system.

The differences between IT and NICs have often been cited as a major source of complexity in the UK's tax system and, in this review, the OTS was asked to consider the impacts, costs and benefits and the steps necessary to achieve closer alignment. This builds on our earlier research and recommendations:

- our 2011 Small Business Review included a key recommendation on the integration of IT and NICs; the government accepted the recommendation and initiated a project on integrating the operation of the two levies
- our 2013 Review of Employee Expenses and Benefits highlighted the differences between IT and NICs, recommending further work to establish the benefits of aligning the position across benefits in kind
- our 2015 Employment Status Review, reiterated that a structural change to more closely align IT and NICs would remove complexity from the administration and potentially be an indirect way of simplifying the employed / self-employed divide

Our terms of reference and methodology

This review develops all these themes, considers existing evidence on the case for change, and presents further research from analysts, stakeholders groups and taxpayers. In particular we looked at the distortions created by differences between the two regimes, and the impact these have on business and individuals (as both taxpayers and benefits recipients). Our Terms of Reference are at Annex A, and a comprehensive list of misalignments and differences can be found in Annex G.

Our review did not cover the complete merger of IT and NICs (although we received a great deal of comment in favour of this), the extension of NICs to pensions and non-earned income, such as interest and rents, and IR35. All these were outside our scope, though we have inevitably had a lot of comment relating to IR35.

During the course of our review we held over 50 meetings with interested parties, all of whom were keen to engage with us and had firm views on the issue. A list of the people we met, or from whom we received formal submissions, is at Annex D. We have worked closely with the Department of Work and Pensions (DWP), the Department for Business, Innovation and Skills (BIS), HM Treasury (HMT) and HM Revenue & Customs (HMRC), both policy and operational officials. We also ran two on-line surveys, for individuals and tax professionals respectively. 600 respondents completed the surveys, and their responses are summarised in Annex C.

Throughout the review a question we posed was to understand the nature of the 'prize' in achieving closer IT / NICs alignment, how it could be valued, and how we could quantify the

challenges in getting there. The prize was not always framed by stakeholders purely in terms of simplification or cost savings.

Our headline findings

Based on all this evidence and supported by data from HMRC analysts, we have identified some overriding principles and a clear desire for change from stakeholders

- the current NICs system no longer supports the UK's flexible workforce model, diverse business structures and flexible reward
- the inherent complexity of NICs means the regime is not well understood by employers or individuals, and is complex to administer
- there is a distortion built into the system – two individuals with the same gross income, constituted differently, may have very different NICs outcomes, and possibly be entitled to different benefits; some employers use the NICs structure to decide work patterns (part time / self-employed).

What follows are our main recommendations, framed as key steps to closer alignment. They are designed as a package and intended to be taken forward as such to achieve major reform. That will take time: ideally there would be a well-signposted path to a time of major change. One reason for presenting these steps as a package is that many are interdependent or are facilitated by others. But we have also tried to indicate which steps can be done separately on a 'standalone' basis.

Key steps to closer alignment

1. Moving to an annual, cumulative and aggregated (ACA) assessment period for employees' NICs on employment income, similar to PAYE IT, would achieve a simpler and more inclusive system. This would address the headline finding that the current structure of NICs is no longer fit for purpose for a modern flexible workforce, and creates distortions – see Table 2.B for an example. It would necessitate a NICs code for individuals, similar to that of a tax code.

Positive impact: This would create a straightforward system that is clear, harmonious and, once bedded down, simpler to understand and to administer. Employees will need to have the implications clearly explained and phased in: some of those with more than one job below the NICs threshold would pay NICs but would get access to work related benefits for the first time. There would be some administrative benefits for employers and HMRC, once established.

Concerns and challenges: the change would create 'losers' as well as 'gainers'. HMRC estimates¹ are that 6.3 million would pay more NICs but 7.1 million would pay less (and these tend to be lower earners – see Chart 2.A).² Any change will require timetables sufficient for the changes to be seamlessly absorbed; employers will be required to implement the new arrangements, HMRC will need to be able to administer the process smoothly and employees time to adjust to the change.

¹ An explanation of these figures is given in Chapter 9. These are estimates for a single year and figures and circumstances are naturally subject to change.

² Low earners whose NICs change may well have consequent benefits changes. Someone paying more, is likely to receive more in universal credit and other means-tested benefits as their entitlement will rise in proportion to the decrease in their net income (though the same is not true of tax credits).

We recommend that the OTS continues work to fully explore the impact of ACA on individuals, businesses, the exchequer and the administration, and sets out options and choices for consideration prior to any implementation.

2. Basing employers' NICs on whole payroll costs would make it easier to understand and reduce distortions created by the current system, such as any incentive for fragmented hours. The consultation found that, in principle, this would be welcomed by employers, creating a system that is simpler to understand and a tax that is easier to calculate. In addition, the name should be changed to more closely reflect its role and purpose.

This proposal could go ahead in isolation from ACA above but complements it.

Positive impact: a simpler system, easier to understand and administer; we assume that the overall receipts raised from employers' NICs would remain the same although some would pay more and some less; the new tax could be set at a lower rate (perhaps 10%, or higher with an allowance) than the existing 13.8% rate in order to achieve this.

Concerns and challenges: this essentially replaces an existing tax and so is not necessarily an obvious simplification.

The impact in certain sectors would need careful consideration, and it potentially does not address the incentives for engaging self-employed workers through a variety of structures.

The consequential impact on the labour market around part time employment (recognising that some employees choose to work part time) needs to be understood.

We recommend that the OTS fully explores the impact on individuals, businesses, the exchequer and the administration, to include the sectoral impact, of a move to a payroll based charge, and sets out options and choices for consideration prior to any implementation.

As the link to individuals' NICs calculations will no longer apply, we also recommend changing the name of Class 1 Secondary NICs, perhaps to Payroll Levy.

3. More closely aligning the NICs position for the UK's 4.7 million, and rising, self-employed with that of employees,³ would remove complexity and potentially converge benefits entitlements. This is increasingly necessary as more people have both earnings and self-employed income. We note and support the recent BIS review of the self-employed which makes similar recommendations for convergence, and the current HMRC consultation on Class 2 and Class 4 contributions.

³ ONS Employees and self-employed by industry: EMP14

<http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/employeesandselfemployedbyindustryemp14>

The self-employed figures in these tables include those who engage through personal service companies. There are some 3.5m individuals who are self-employed taxpayers, <https://www.gov.uk/government/statistics/earned-income-2010-to-2011>

Positive impact: from the evidence we have collected to date, it appears that, in principle, these alignments would be widely supported. The consultation found a general view that the self-employed would accept paying more NICs in return for more benefits (eg some form of sickness / unemployment benefit).

Concerns and challenges: evidently, this proposition would need to be thoroughly tested and understood by all groups. Timetables would need to be constructed that allowed smooth change.

There is also a clear need to coordinate government moves in this area, building on the OTS's joint employment status working party recommendation, accepted in the Autumn Statement 2015.

We recommend that the planned HMRC / HMT / DWP / BIS working group on employment status is expanded to include the OTS and also considers the position of the self-employed with a view to considering harmonising rules and procedures.

The OTS should also be formally involved with the group and the wider policy debate, to help drive policy solutions that simplify and appropriately balance matters for the self-employed.

We recommend bringing the NICs position for the UK's self-employed towards that of employees, to remove complexity and potentially to converge benefits.

We also recommend ensuring that what is liable to IT for the self-employed is also liable to NICs.

4. To help make closer alignment possible, NICs needs to be a more transparent system.

Confusion abounds about the contributory principle with much misunderstanding about its real impact. Many question its continuing relevance; but many others see it as a cornerstone of our tax and welfare system. On pure simplification grounds the OTS could argue for its abolition, with consequent administrative savings for HMRC, but much work would need to go into consideration of the consequences.

Positive impact: better explanation of the contributory principle and the benefits that flow from it will mean the system is better understood and better trusted by taxpayers, with the potential to be seen as simpler. Transparency is a natural progression of the digital agenda.

The contributory principle should be critically examined and, as a first step, there should be a better informed debate to enable the government in (say) five years' time to take a decision on its future. That means, for the moment, a commitment to explaining the contributory principle and its consequences. Alongside, we recommend that NICs transparency for taxpayers should be enhanced to improve understanding and allow people to make informed choices⁴. Greater visibility can be achieved through HMRC's personal tax accounts. The government should promote the debate, but plan to involve other interested parties, unions for example, and those representing the low-paid.

⁴ This could include dropping the terms 'Classes' for NICs and instead labelling them what they are: Employees, Self-employed, Voluntary and Employers.

Chapter 8 sets out in more detail the workings of the National Insurance Fund, which is little understood by taxpayers.

We recommend that NICs transparency for taxpayers should be enhanced to improve understanding and allow people to make informed choices. Greater visibility can be achieved through HMRC's personal tax accounts.

The aim should be to ensure proper understanding so that any future debate about the contributory principle is based on a full understanding of the facts.

5. 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.

This would make it easier for individuals and employers to understand, and improve compliance. Aligning the reliefs available for IT and NICs would create a more equal system for employees and reduce the admin burden of managing the differences for employers.

Positive impact: there would inevitably be savings from having rules and an administration that are more straightforward and understandable. There would potentially be a small reduction in NICs receipts due to increased expenses deductions, potentially this could be partly balanced by a slight increase due to aligning the scope of the two charges.

Concerns and challenges: This could result in an increase in the volume of expenses claims to be processed by HMRC but we expect IT and NICs claims will be made together so the increase should be small and automation will help significantly. The impact on the individual's contribution record would need to be understood, as well as those sectors where employees are not normally reimbursed but incur high levels of business expenses.

We recommend that HMRC and HMT should commit to the principle of aligning the scope of IT and NICs on employment income and the reliefs available against each charge (apart from very limited defined exceptions) over a period and should ensure no new divergences are introduced.

6. Bring taxable benefits in kind (BiKs) into Class 1 NICs and abolish Class 1A NICs. Bringing all taxable BiKs into Class 1 and abolishing Class 1A NICs would simplify the administration and reduce the possibility for error, and also remove distortions in the NICs treatment of non-cash remuneration. It is noticeable that concerns about this in earlier OTS reviews have largely evaporated, to be replaced by strong views that the current system is inequitable and creates unfairness. This would be facilitated by the ACA change above and by payrolling, but neither are absolute pre-requisites.

Positive impact: an employee's NICs bill would no longer depend on whether the employee is rewarded with cash or non-cash benefits, creating greater parity amongst employees.

Concerns and challenges: for employees, there would be a NICs liability on BiKs where none had existed before. For modestly paid employees there could be a noticeable difference in their take home pay. The extra NICs yield could be balanced by a general reduction in rates.

We recommend that there should be a commitment to harmonising the NICs treatment of benefits in kind and cash rewards over a suitable period. The OTS notes that there will be a need to fully explore the impact on individuals, businesses, the exchequer and the administration of a move to alignment.

7. A fully joined up approach to the two taxes across policy and administration requires the alignment of legislation and procedures, and where possible the matrix of rates and thresholds. HMRC guidance and support needs to be better linked and a legislative route found to ensure that changes to IT and NICs are simultaneous and equivalent.

Positive impact: all these issues at present drive complexity and so costs, particularly for small businesses, and closer alignment would reduce potential for error and improve compliance.

Concerns and challenges: we have considered whether NICs could be changed within a Finance Bill (see Chapter 13), but it is clear that it would be difficult to change this feature of Parliamentary procedure.

We recommend cross-referencing the IT and NICs position in HMRC guidance and legislation, and that there should be more explicit consideration of the interaction between IT and NICs in policy development.

The differing IT and NICs rules around procedures such as discovery assessments and time limits for debt recovery should be harmonised.

We recommend that new thresholds are not introduced in circumstances where existing ones can serve the same purpose, and that existing thresholds are reviewed to establish which may be aligned (and then remain linked). Aligning the NICs primary and secondary thresholds would be a good place to start.

NICs legislation should be changed in such a way that future relevant IT changes would automatically apply to NICs as well.

We recommend aligning the legislation and procedures, and where possible the matrix of rates and thresholds. HMRC guidance and support needs to be better linked and a legislative route found to ensure that changes to IT and NICs are simultaneous and equivalent.

Impact on the digital agenda

We believe that all of our recommendations are very much in line with HMRC's digital agenda. Some will make the digital systems easier to introduce and operate (eg common definitions); some are facilitated by the digital methods (eg annual, cumulative and aggregated NICs).

International aspects

We considered international social security arrangements and found that no model stands out for its simplicity, indeed some commented that the UK has an easier system to understand in that there is only one social security levy. In contrast some countries disaggregate contributions into many separate charges (which along with other difficulties in administration, gives rise to very complex payslips). Annex E provides a more detailed comparison.

We recognise that internationally mobile employees pose a particular challenge and that simplifications are needed. More consideration is required **to develop recommendations in this area and the OTS plans to do further research and work in these areas (and also to include exceptional cases and discrete industry sector groups).**

Conclusion and next steps

There was not time in this review to complete a full costs and benefits analysis of all our recommendations, but we have done enough work on these impacts to support the case for change. The next stage, assuming ministers accept in principle the case we have made, will be to establish in more detail, and consult on, the impact of our recommended changes. This work could also usefully probe further sectoral impacts and administrative savings, including for HMRC.

We reiterate the recommendations from our previous reviews, that aligning IT and NICs will bring simplification. The key change in many ways is to improve transparency around NICs in particular: that greater transparency will encourage taxpayers to understand the contributory system and make informed choices. Together these changes will remove distortions and make the system more equitable - a key desire across all our stakeholders - more understandable and hence simpler.

1 Transparency and the contributory principle

1.1 Before considering detailed differences between Income Tax (IT) and NICs, there is perceived to be a distinction in the underlying nature of the two taxes, arising from the role and nature of the contributory principle in NICs. There is also a lack of transparency about these issues.

There are constitutional differences between IT and NICs

1.2 IT is paid into the Consolidated Fund (CF) and used for general purposes. There is no formal link between IT paid and public services received by individual taxpayers.

1.3 The major part of NICs (80%) is paid into the National Insurance Fund (NIF) and used to fund certain benefits, the entitlement to which depends on an individual's record of contributions. The remaining 20% of NICs pays for about 20% of the costs of the NHS. (The other costs of the NHS, along with non-contributory benefits and many other services, are paid for from the CF.) 94% of the benefits funded by the NIF are state pensions.¹

1.4 The NIF is underpinned by the availability of support from the CF and in 2014-15 a transfer was made in a substantial sum (£4.6 billion) for the first time since 1997-98.

Summary of views on the differences and distortions between the roles of IT and NICs:

- very wide ranging views were expressed on the current level of understanding amongst taxpayers of the contributory principle and the role of the NIF, and whether the NIF should be abandoned (other than the minimum required for international treaties) or the contributory principle retained
- some regard NICs as having almost a fraudulent base in that taxpayers are misled to believe NICs are tightly ring-fenced for use on social security benefits and (significantly) the NHS
- many argue that developments in the state pension mean the contributory principle is of little continuing relevance; others feel strongly that it is a cornerstone of the tax system and should be enhanced
- others, while recognising that there is a degree of fluidity between the NIF and the CF, consider that the higher regard in which NICs are perceived (as a tax which has a linked and clear purpose) is a feature which should be encouraged
- in recent years, reductions in rates of IT and increases in the IT personal threshold have been much more significant than changes to NICs rates and thresholds. Some feel this demonstrates an exploitation of the lack of transparency for taxpayers of NICs compared with IT

1.5 We found significant, but not majority, support for almost all these views. In contrast IT is perceived to have a clearer purpose.

¹ Sources for these figures are given in Chapter 8.

1.6 Transparency is an important element of a simpler tax regime because it enables taxpayers to understand and comply with their obligations, and challenge their liabilities as appropriate. For NICs, transparency has a further role in helping individuals understand and build social security entitlements.

1.7 Lack of transparency and understanding means that the system is perceived to have distortions for example:

- in relation to the link between NICs and benefit entitlements there is not, and is not intended to be, a perfect and proportionate match between NICs and benefits, so some outcomes may seem unfair. For example entitlement to contributory jobseekers allowance is based on recent contributions records only and ignores older records
- as NICs are collected by job and by pay period, rather than by reference to income from all jobs ('aggregation') the benefit entitlement of someone with multiple low paid jobs may differ from the entitlement of someone receiving the same in aggregate from a single job (there is further analysis in Chapters 2 and 9)

The contributory principle

1.8 At its simplest the contributory principle is the idea that social security benefits are entitlements gained by making contributions, combining aspects of reciprocity (that something paid leads to a benefit) with community (that the return is not precisely linked to the payment). This is broadened in the UK by the role of NICs in partially contributing to the costs of the NHS (although this does not, of course, affect entitlement to NHS treatment, contrary to the belief of some respondents to our survey).

Recommendations

1.9 If the contributory principle is to remain, it should be understood by those it applies to. Changes to NICs recommended elsewhere in this report will give an opportunity to increase the understanding of taxpayers about what the principle is and why it matters. At a general level the scope and purpose of the contributory principle and the role of NICs should be set out clearly.

1.10 At an individual level, greater transparency of NICs could be achieved if more information were provided in the online tax account, distinguishing NICs from other tax payments and showing the destination of NICs and any resulting entitlement separately.

1.11 We support work already underway to place information online for individuals about their own contribution records and state pension entitlements. We recommend that the potential is explored for extending this to include other contributory benefits and that this information is linked to individuals' new online tax accounts.

1.12 State pensions have a key status in the NIF. Following the simplification of state pension entitlements from April 2016 it will be more straightforward to explain the purpose and mechanics of the relationship between contributions and entitlements.

1.13 Greater transparency would:

- seek to address anxiety on the role of NICs and so potentially enhance support
- improve taxpayers' understanding of NICs and so perception that the system is simpler
- enable taxpayers to make informed decisions on whether they should seek to add to their contribution record

1.14 The challenges would be:

- the degree of commitment required
- overt recognition that NICs are a tax

1.15 This recommendation is contingent on the introduction of NICs records in the online tax account, but implementation is not required in order to make other alignments or recommendations possible. We see this as a medium-term change that could be achieved over two to three years. Once this is completed and there is better understanding of the contributory principle, then its continuing place should be critically examined, especially as by then state pension changes will have bedded down.

1.16 As part of improving transparency, once the Class 2 / Class 4 combination is effected, remove the notion of 'Classes' of NICs and simply have four categories – Employees, Self-employed, Voluntary and Employers² to keep the language and the concepts easy for taxpayers to understand.

NICs and earnings of those over State Pension Age (SPA)

1.17 One issue serves as an example both of the legacy of previous changes to NICs and of how NICs fits with the broader concept of the contributory principle. Those aged over SPA have a well-known exception from paying NICs on employment income. There is no comparable exception for their employer. What is less well-known is that the basis of the exception was that anyone over SPA earning above a certain amount had their pension progressively reduced. This earnings rule was abolished in 1989 but the earnings exception remains.

1.18 In an era of increasing life expectancy, with more people working past SPA, this exception needs to be examined. There are two broad views:

- why should people continue to pay NICs when they cannot accrue a greater state pension?
- as NICs are a general levy, there is no reason to continue this exception which will be increasingly illogical as working trends continue to develop

1.19 The first view has some validity but misses the point that the NICs contributory principle is about far more than securing one's own pension. The second point is a fairness issue - why should one group of workers pay less in tax than another group?

Box 1.A: Recommendations

NICs transparency for taxpayers should be enhanced to improve understanding and allow people to make informed choices. Greater visibility can be achieved through HMRC's personal tax accounts. This should in time lead to a critical examination of the contributory principle.

The aim should be to ensure proper understanding so that any future debate about the contributory principle is based on a full understanding of the facts.

² In Chapter 3 we recommend changing the name of employers' NICs if the structure of the tax is changed.

2 Changing the structure of employees' NICs

There are fundamental differences in the periods of assessment for IT and employees' NICs.

2.1 An assessment period is the period of time in respect of which the assessment of the amount of tax payable is calculated. The terms annual, cumulative and aggregated are explained in more detail at Chapter 9 at paragraph 9.8.

Table 2.A: Summary explaining assessment periods for IT and NICs

| | Income Tax | Employees' NICs |
|---|--|--|
| Period of assessment | Annual | Each earnings period eg weekly or monthly (though directors use an annual period) |
| Basis of calculation | Cumulative through PAYE using an IT code – the total pay and tax deducted in the tax year to date are taken into account in each new earnings period | Non-cumulative. NICs in each earnings period is calculated in isolation without reference to any previous pay or NICs deductions in that tax year, using a NICs category letter |
| Is liability aggregated over all employments within the tax year? | Yes. Total liability for the year is calculated after aggregating earnings from all employments (and other sources of income) | No. Each separate employment is treated in isolation |
| Is an annual reconciliation necessary to determine liability? | Yes, following the end of the tax year, to ensure that the right amount of tax is charged on total annual income - from all employments and other income | No - unless the employee has paid more NICs than required (normally due to the individual having more than one job, or is in self-employment as well as PAYE employment) when the excess is refunded |

2.2 The weekly / monthly structure of NICs was established when employees were less likely than they are now to move between jobs, have multiple concurrent jobs or jobs with fluctuating incomes (perhaps as a result of zero hours contracts). As such features of employment increase in significance, more individuals will be impacted by the different assessment periods for IT and NICs.

There are two key distortions created by having different assessment periods.

2.3 While the IT paid in each situation outlined below is the same, the NICs due on the same amount of employment income differs. The situations cover two variables:

- where income is received from one employer, compared with the same total income from multiple employers (concurrently or consecutively); and
- where income is received in a single week or month, compared with the same income received spread through a year

Table 2.B: Table illustrating the different outcomes for a total annual income of £15,000 in 2015-16

| Income | 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 3 employers spread equally over 12 months | £880 | £0 | £880 |

These differences can also impact the benefit entitlements of individuals.

Summary of views on differences in periods of assessment

2.4 Moving to an annual, cumulative and aggregated (ACA) basis for NICs was overwhelmingly the most common reform sought by our respondents. The prime concerns with the current NICs approach were:

- it is not fit for current working patterns
- the differences with IT cause confusion
- the distortions described in Table 2.B above (which are seen as unfair)
- it is difficult to achieve accuracy within the present earnings period timeframes and associated problems obtaining NICs refunds

2.5 There was, however, anxiety about the scale of such a change, whether HMRC has adequate resources to implement it, and the costs of change for employers. Also, although change is considered highly desirable, those we met could not identify very significant administrative savings from a new approach for employers, although we think that there is the potential for useful savings for HMRC once the system is established.

2.6 The biggest question raised was inevitably the 'gainers / losers' issue. As is clear from Table 2.B above, some will pay more NICs under this ACA system, though equally some will pay less. The important balance for those paying more is that many will gain entitlement to benefits and it was this factor that led to wide support for the change among bodies representing the low paid and unions. There was some natural caution but strong feelings that an ACA system would be more equitable, fairer and easier to understand.

Ways of aligning the assessment periods

2.7 There are various options to align assessment periods more closely, described in Chapter 9. On the basis that simplification (while maintaining two separate taxes) is best achieved by:

- improving transparency
- using similar calculation principles and mechanisms for NICs similar to those which already exist for IT
- removing distortions
- avoiding new complexities

2.8 We recommend that an annual, cumulative and aggregated (ACA) approach is used for NICs, with the introduction of a NICs code, comparable to the current PAYE code. We explore the mechanics and alternatives of the NICs code in Chapter 9.

2.9 The advantages would be:

- clearer and fairer NICs liabilities, with distortions in the system removed, that is directly comparable to the IT system
- individuals with multiple low paid jobs could find it easier to build a contribution record
- an annual NICs allowance for all individual earners, whether employed or self-employed
- greater understanding of the NICs system, and easier to operate under a digital regime

2.10 Overall impacts following a move to an ACA basis for employees' NICs would be:

- while the exchequer would gain, this masks potentially positive and negative impacts for some significant groups of employees,¹ 7.1 million workers would pay an average of £175pa less NICs (£1.2 billion in total), and 6.3 million workers would pay on average £275pa more NICs (£1.7 billion in total)
- in general, those who would pay less NICs in the future have lower incomes than those who would pay more (see Chart 2.A below)
- the extent of the impact on individuals in different circumstances is not yet fully clear, in particular there may be variations in the impact on employees in different economic sectors, for example those which rely particularly on part time workers
- there will also be impacts on benefits entitlement with some gaining eligibility: if some people pay more, they are likely to receive more in benefits entitlement with increased entitlement to universal credit and other means-tested benefits as their entitlement will rise in proportion to the decrease in their net income (though the same is not true, of course, of tax credits).

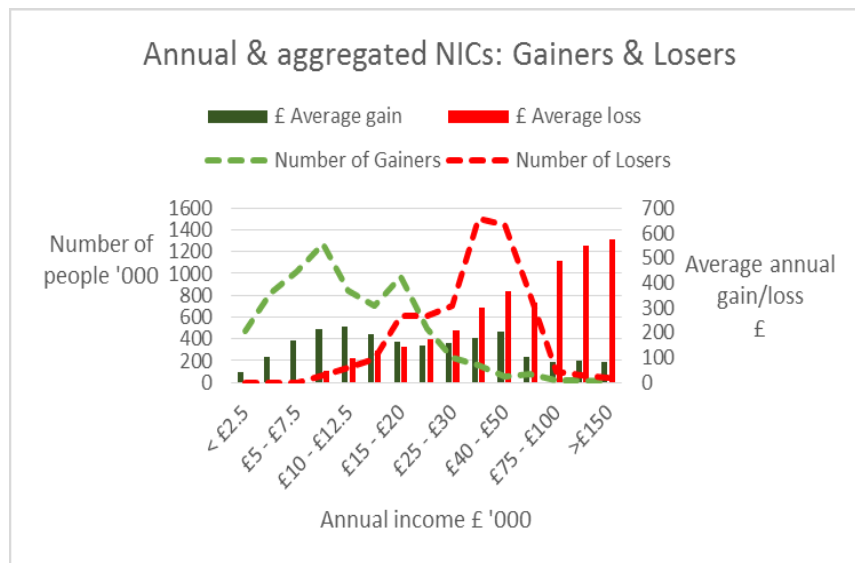
2.11 The challenges of this alignment would be:

- this is a complex change to implement, for business and HMRC and for individuals to understand (however for individuals it will be facilitated by RTI and HMRC's Personal Tax Account)
- the change will probably require a separate NICs code to be allocated to taxpayers (similar to the familiar IT code) instead of the current NICs category letter
- in relation to benefit entitlements there are two key issues which must be worked through:
 - procedurally, how to link an annual, cumulative and aggregated contribution mechanism with an entitlement structure which (other than for the state pension) is partly based on the existence of weekly contributions records, and
 - the consequential impact on individuals' entitlements and the cost of those changes

All these figures and impacts need to be probed and tested.

¹ More information on the detailed methodology is at Chapter 9. These are estimates for a single year and figures and circumstances are naturally subject to change.

Chart 2.A: Indicative overall 'gainers' and 'losers' from moving to an annual and aggregated basis – it shows the number of people impacted at different income levels and the average annual gain or loss at those income levels



2.12 Employment patterns are becoming increasingly complex, and any delay in implementing this change to a simpler and more equitable structure for NICs will make the change increasingly difficult. Yet, the more complex that employment patterns become, the harder it will be to make the case for keeping the current structure, with all its complexities and distortions.

2.13 This alignment is not contingent on the following issues, but does have implications for:

- employers' NICs (see Chapters 3 and 10)
- entitlements to contributory benefits (Chapters 1 and 8)
- legal liability for paying NICs (see Chapter 9)
- those who have employment and self-employment income (see Chapters 5 and 12)

2.14 It helps make more closely aligned bases for IT and NICs possible (see Chapters 4 and 11), and a potentially a common definition for residence for IT and NICs.

Is this a short, medium or long-term change?

2.15 This alignment would be a fundamental shift in the method of calculation, requiring confidence in the ability of HMRC to design the mechanism and to apply sufficient resources to the implementation and on-going support for the new approach. We consider that a change of this magnitude requires a lead time of at least five years.

Box 2.A: Recommendations

We recommend annual, cumulative and aggregated assessment periods for employees' NICs on employment income as a way of achieving a simpler, more equitable and thus fairer system.

Further review is needed of the potential impacts of implementation on groups of individuals, with better data established and published to ensure that there is support from all parties. Consideration needs to be given to transitional methods to smooth the changes.

We recommend that the OTS continues work to fully explore the impact of ACA on individuals, businesses, the exchequer and the administration, and sets out options and choices for consideration prior to any implementation.

Employers' national insurance

3

Employers' national insurance is a key difference from Income Tax (IT)

3.1 IT on employment is a charge on an individual collected by the employer, whereas NICs is a charge on both the individual employee (called 'employees' NICs', and which may impact the employee's entitlements to welfare benefits) **and** the employer (called 'employers' NICs'¹ and which has no bearing on an employee's welfare benefits).

3.2 There is no equivalent NICs charge for self-employed taxpayers, so contracting with the self-employed can be cheaper for employers than hiring employees (though this would not be the only reason for contracting with the self-employed)².

3.3 This difference creates distortions, for example:

- the impact of the secondary threshold on employment practices eg low paid zero-hours contracts, part-time and seasonal workers
- the treatment of employment status, eg 'off payroll' workers such as managed service companies, umbrella companies

Summary of views on employers' NICs, differences and distortions

3.4 There is concern that the name of the tax masks its real nature and a lack of understanding as to how an employers' charge fits into the overall scheme of National Insurance. Few employees understand it; some employers are concerned that employees are not aware of the significance of NICs paid by their employer, with some commenting that employers' NICs is a conveniently hidden tax which makes it easier to increase.

3.5 Respondents recognised that the presence of a threshold for each employee before employers' NICs is due may encourage employers to offer low hours (with associated low pay) but little concrete evidence for this was offered. Respondents acknowledged that their enthusiasm for an annual and aggregated basis for employers' NICs (see Chapter 9) is likely to trigger change in employers' NICs.

Recommendations for redesigning employers' NICs

3.6 Of the potential options described in Chapter 10, we recommend Option C (set out in more detail there), to:

- break the present link with the calculation of individual employees' NICs and discard the secondary threshold
- instead base employers' NICs on payroll totals in the year, with interim payments based on each month's payroll (now potentially including payrolled employee benefits, see Chapters 4 and 11)

¹ Formally, Class 1 Secondary NICs

² OTS Employment Status Report 2015,

www.gov.uk/government/uploads/system/uploads/attachment_data/file/422248/OTS_Employment_Status_report.pdf

- continue the concept of an Employment Allowance, or overall threshold (as in the Apprenticeship Levy) (while recognising that any design which includes a significant Employment Allowance would need to include anti-abuse provisions)
- build benefits in kind and PAYE settlements into the final payroll total for the year, to replace Class 1A (employers' NICs on benefits in kind) and Class 1B (employers' NICs on PAYE Settlements)

3.7 We also recommend changing the name of Class 1 Secondary NICs as it will no longer have any connection to employees' NICs. We suggest Payroll Levy as a starting point but the new title is something for debate once the change is agreed in principle.

Table 3.A: This table gives examples of the implications of different flat rates, combined with allowances, raising the same funds as the current employer NICs regime.³

| Flat rate | Employer allowance | Implied employer pay bill which would not incur a liability | Number of employers with no liability | Number of employers with a liability |
|-----------|--------------------|---|---------------------------------------|--------------------------------------|
| 10% | Nil | N/A | Nil | All |
| 11.5% | £115,000 | Up to £1m | 1.51m | 40,000 |
| 13.5% | £675,000 | Up to £5m | 1.54m | 10,000 |

3.8 The advantages of this recommendation:

- it would be a simpler tax to calculate and explain as no longer directly linked with complex employees' NICs
- it would reduce the incentive to fragment hours of work offered, giving employees a better opportunity to build an overall wage from fewer jobs
- there is potential alignment with the new apprenticeship levy and the employment allowance

3.9 The challenges in achieving this recommendation:

- it introduces a new type of tax
- some employers will pay more, some less
- it does not address employers' incentives to require individuals to contract as self-employed
- the name change must be achieved without disturbing existing social security double contribution agreements

3.10 This alignment is not contingent on the adoption of annual, cumulative and aggregated employees' NICs and it could be adopted on its own. The decision on whether to proceed with these proposals for employers' NICs should be taken on its own merits.

Is this a short, medium or long-term change?

3.11 Although potentially the introduction of a different form of employers' NICs could precede annual, cumulative and aggregated employees' NICs (which we would expect to take five years

³ Source: OTS estimates based on information provided by HMRC.

to implement), a concurrent change would reduce the impact of two successive significant changes.

Box 3.A: Recommendations

NICs charge on employers should be based on whole payroll costs to make the charge easier to understand and reduce any incentive to offer fragmented hours.

We recommend that the OTS fully explores the impact on individuals, businesses, the exchequer and the administration, to include the sectoral impact, of a move to a payroll based charge, and sets out options and choices for consideration prior to any implementation.

As the link to individuals' NICs calculations will no longer apply, we also recommend changing the name of Class 1 Secondary NICs, perhaps to Payroll Levy.

4 Aligning the tax bases for employees

Introduction

4.1 Employers and employees both have to follow two different sets of rules to determine what should be subject to Income Tax (IT) and NICs. The results are similar, but there are significant and fiddly differences. Before looking at our recommendations on how to remove these differences, there follows a summary of the structural differences between the two charges. For a comprehensive list of all the differences between IT and NICs please refer to Annex G.

Overview of the differences between the IT and NICs legislation

4.2 The principal employment taxes act, ITEPA 2003, charges IT on employment income which constitutes both 'general earnings' and 'specific employment income':

- 'general earnings' includes 'earnings' and items 'treated as earnings' such as benefits including company cars or private medical insurance
- 'specific employment income' includes some termination payments, some employment related securities, payments that fall within the disguised remuneration regime and other payments

4.3 The principal NICs act, Social Security Contributions and Benefits Act 1992 (SSCBA 1992), charges Class 1 primary and secondary NICs on earnings paid to or for the benefit of an employed earner (with the exception that employees above pensionable age do not pay primary Class 1 NICs). It also allows for other items from an employment to be treated as remuneration and earnings. In addition SSCBA 1992 allows for a Class 1A NICs charge on items that are treated as general earnings under ITEPA but which fall outside the charge to Class 1 NICs.

4.4 Both charges apply to 'earnings', but each charge has its own definition of 'earnings'. Furthermore the rules for additional items are similar but not identical. There is much cross-referencing to ITEPA in the NICs legislation, but it is not comprehensive.

4.5 The approach to reliefs for IT and NICs differ. For IT there are both exemptions and deductions. The effect of an exemption is to prevent the item being treated as taxable income in the first place, whereas the effect of a deduction is to reduce net taxable earnings. In the social security legislation there are only 'disregards' which have the same effect as an exemption, but no deductions.

4.6 Table 4.A summarises the main differences in the tax bases between IT and NICs.

4.7 In the next three sections we consider recommendations on:

- aligning what is in the scope of the two charges
- aligning the way that reliefs are available for IT and NICs
- aligning the treatment of benefits in kind

Table 4.A: This table summarises the main differences in the tax bases between IT and NICs

| | Income Tax | NICs |
|------------------------|---|---|
| Definition of earnings | 'any salary wages or fee, any gratuity or other profit' | 'any remuneration or profit derived from an employment' |
| Additions | Various items 'treated as' earnings and other types of 'specific employment income' | Various items treated as remuneration and earnings |
| Reductions | Various items exempted from tax charge | Various items disregarded from NICs liability |
| | Various deductions from taxable amounts | |

Aligning the tax bases – the scope of the charges

The rules on what items fall within the two charges, IT and NICs, are not aligned.

4.8 There are two different definitions of 'earnings' for IT and NICs. The NICs definition is broader - 'remuneration or profit derived from an employment' as compared with anything that constitutes 'an emolument of the employment' for IT. See Chapter 11 for the full definitions.

4.9 There are payments which do not fall within the IT definition of 'earnings' but are still taxable as employment income. These payments may be 'specific employment income'. Under the NICs legislation various items are 'treated' as remuneration and earnings. However, the two sets of rules do not always coincide, as is the case for termination payments.

These differences create some distortions

4.10 NICs avoidance which exploited the difference in the earnings definitions diminished after the NICs legislation was amended to treat assets that could be readily converted into money as earnings and to charge payments in kind that are not 'readily convertible assets' (RCAs) to Class 1A NICs. However, there is also a small but growing body of case law that has arisen from occasions where the difference has caused difficulty.

4.11 The problems with the differing scopes of the charges extend beyond the different definition of earnings. Termination payments are the most commonly mentioned distortion, producing a particular possibility for error. Payments over £30,000 that are not 'earnings' for IT or NICs, are taxable as specific employment income, but are not subject to NICs. Often employers apply NICs to termination payments when they are not required to, and end up making NICs overpayments. We support the current review and consultation on termination payments and add that, from the point of view of simplification and the OTS's current project, the NICs treatment should follow the IT treatment.¹

Summary of views on the different definitions and distortions

4.12 We were told that differing definitions of 'earnings' do not in themselves seem to cause problems for most payroll experts on a day to day basis as there are only limited exceptions. So

¹ www.gov.uk/government/consultations/simplification-of-the-tax-and-national-insurance-treatment-of-termination-payments

perhaps, at first glance, alignment is not absolutely essential. However, there are strong views that:

- the rules for NICs should follow the rules for IT
- any future changes in IT treatment, actual or proposed, should automatically apply for NICs as far as employment income is concerned
- there needs to be common terminology between the two imposts - eg IT speaks of 'exemptions' while NICs use the term 'disregards' (see section on reliefs)
- NICs legislation should adopt Tax Law Rewrite style and terminology
- to the extent that it does not already do so, the NICs legislation with regard to employed earners should cross-refer to ITEPA

Taken together, these make a strong case for aligning the definitions of 'earnings' and the wider employment income legislation and corresponding NICs legislation.

Ways of aligning the scope of the charges

4.13 Alignment of the definitions of 'earnings' and the wider bases of IT and NICs could be achieved in the following ways:

- the NICs legislation could be rewritten to reflect IT legislation
- provisions in the NICs legislation on what is in scope of the charge could all cross-refer directly to tax legislation

The second option would require the least maintenance and drafting after alignment.

4.14 It should be noted that DWP rely on the current definition of earnings in SSCBA for the purposes of, for example, statutory payments and student loans. In the event that the definition for NICs purposes is amended, DWP would need to decide whether to align with the revised NICs legislation.

4.15 The advantages of greater alignment are that it would be easier for employers and employees to understand, and it would help improve compliance. Some of these changes would disturb existing case law and the consequences of such disturbance need to be established and managed. This alignment is not contingent on any other alignment, change or factor, but would make it easier to propose and implement other alignments. We think this alignment could be achieved in two to three years.

| | |
|---|--|
| <p>IT statutory reference: s.62 ITEPA 2003 s.7(4) ITEPA 2003 Parts 6,7 and 7A ITEPA 2003</p> | <p>NICs statutory reference: s.3 SSCBA 1992 SI 2001/1004 – the Social Security (Contributions) Regulations 2001</p> |
|---|--|

Box 4.A: Recommendation

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.

Aligning the tax bases – expenses, deductions and other reliefs

Business expenses

4.16 The IT and NICs legislation have slightly different definitions of qualifying business expenses, but the difference in the treatment of business expenses is greater than that. It is a particular problem for employees who fund their own business expenses and are not reimbursed by their employers.

4.17 Tax relief for qualifying business expenses is by ‘deduction’ from earnings and also, from April 2016, by ‘exemption’. An individual can claim a deduction from earnings for IT purposes without any payment being made by the employer in respect of the expenses.

4.18 This contrasts with NICs relief for qualifying business expenses which is provided by ‘disregards’. Under a disregard a payment by an employer in respect of expenses is disregarded or ignored in calculating earnings for NICs – like a tax exemption. A disregard does not allow the employee a deduction if the employee incurs an expense which is not reimbursed or paid for by the employer.

4.19 The same problem arises for employees who are paid round sum allowances in respect of expenses. A general round sum expenses allowance will be included in gross pay for PAYE and Class 1 NICs purposes. At the end of the tax year the employee can make a claim to relief from Income Tax in respect of expenses which qualify for a deduction and get a repayment of the tax over-deducted under PAYE. There is no provision for relief from Class 1 NICs. In theory an employer could analyse the actual qualifying business expenditure by the employee and make adjustments through RTI so that the employee is only subject to tax and NICs on the amount of the round sum allowance in excess of the qualifying business expenditure, but in practice this is unlikely.

Table 4.B: This table sets out a simple example for an employee who spends £100 of their own money on business travel

| | IT relief | NICs relief |
|----------------------------|-----------|-------------|
| Employer reimburses | £100 | £100 |
| Employer doesn't reimburse | £100 | None |

Other misaligned reliefs

4.20 There are further examples of tax reliefs for which there is no corresponding NICs relief:

- payments of interest on qualifying loans are deductible in computing IT liability
- employee contributions (and those of the self-employed) to registered pension schemes are deductible within limits in computing IT liability. (Employer contributions are not subject to NICs)
- charitable payments via the payroll (Give As You Earn or GAYE) are made from employees' gross salaries
- charitable payments made via Gift Aid can reduce the tax liabilities of higher and additional rate taxpayers

4.21 As discussed in Chapter 11 we would suggest that misalignments for GAYE and Gift Aid are a low priority. The added complication for Gift Aid is that it is a relief against all income and not all forms of income are subject to NIC.

These differences create distortions:

4.22 Here are two examples that bring the differences described into focus.

Box 4.B: Example 1 – mileage payments

Employers can pay approved mileage allowance payments (AMAPs) to reimburse employees for business mileage in their own private cars IT and NICs free.

If an employer does not reimburse business mileage, or reimburses at less than the AMAP rates, the IT legislation allows the employee to claim a tax refund, restricted by the AMAP rates. Some employers facilitate the tax refund by confirming the amount that can be claimed on the employee's form P11D or even making a refund claim on the employee's behalf. However, an employee cannot make a NICs reclaim for business mileage when the employer does not reimburse for business mileage or reimburses at less than the AMAP rate as there is no equivalent deduction in the NICs legislation.

A further complication with AMAPs is that the rate for tax is reduced from 45p per mile to 25p per mile after the first 10,000 miles, but it is not reduced for NICs.

Box 4.C: Example 2 – pension contributions

As mentioned above the IT and NICs treatments of employee pension contributions are misaligned.

Employee pension contributions are income tax relieved but attract no NICs relief and so in effect employees still pay Class 1 NICs on the contribution (and the pay used for the contributions is subject to employers' NICs). This contrasts with the IT and NICs treatments of employer pension contributions which are aligned – no IT or NICs (employer's or employees') are due on these.

As a result of this misalignment between the employee and the employer contributions, some employers and employees enter into salary sacrifice arrangements: usually this means that the employee reduces their gross salary and the employer increases their pension contribution. There is a NICs gain for both the employee and the employer which is sometimes used to increase the amount saved into the pension. This creates complexity for individuals and employers but there are no obvious solutions to this that would not involve a major change to the tax and NICs treatments of pensions and, given the current review² on pensions, we have not considered IT and NICs relief on pension contributions any further in this review.

4.23 Representations from stakeholders primarily related to unreimbursed expenses and employee pension contributions. If IT and NICs are to be aligned, thought needs to be given to aligning reliefs as well as to aligning the broader scopes of the charges.

Ways of aligning reliefs

4.24 The NICs legislation could be rewritten as far as policy permits so that it mirrors the IT legislation or cross-refers directly to the IT legislation – this will enable NICs relief to be available

² <https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief>

on the same basis as IT relief. There should be an initial focus on business expenses. This should be done at the same time as the legislation is amended to align 'earnings' and the scope of the two charges.

4.25 The advantages of aligning reliefs:

- employees who are not reimbursed by their employers would no longer be in the position where they are unable to claim a Class 1 primary NICs refund on sums spent on business expenses from which they derive no personal benefit. They would have parity with employees who are reimbursed and also self-employed individuals who deduct expenses in arriving at the profits subject to NICs
- employers would no longer have the administrative burden of organising their affairs to deal with certain misalignments, eg pension contributions and AMAPs
- this alignment would stop the differing IT and NICs treatment of assets provided by employers for both business and private use (mixed-use assets). Currently an IT deduction is available for business use but Class 1A NICs is due on the whole benefit.

4.26 In principle NICs business expense claims will mirror those already being submitted for IT and we expect that employees would make joint IT/NICs claims that are then processed automatically by HMRC for both charges. A potential challenge in achieving alignment will be that the current primary threshold for NICs is lower than the personal allowance for IT. This difference means that the volume of claims for expenses to be processed could increase, implying extra work for HMRC. The difference would also serve as an encouragement for high volume agents who offer to process individuals' expenses claims for a percentage.

4.27 This alignment is in practical terms contingent on transitioning to calculating NICs on an annual, cumulative and aggregated basis so that there can be easier mechanisms for refunding the Class 1 NICs to individuals and to facilitate the calculation of the refunds. None of the recommendations in this report are contingent on the alignment of reliefs.

Further evidence

4.28 Data provided by HMRC suggests that approximately £3.2 billion employment expenses were claimed against IT in 2013-14. If all the individuals who make these reclaims were under the upper earnings limit, ie pay Class 1 NICs at 12%, then this would represent approximately £380 million of employee Class 1 NICs being refundable. In reality, because some employees pay NICs at the 2% rate, a weighted average rate of NICs (perhaps as low as 6.5%) should be applied to predict the potential NICs refunds. However, due to the many earnings periods, fluctuating earnings, earnings from multiple jobs not being aggregated etc., it would be extremely complex to calculate an average rate. Another factor to consider in determining the costs to the Exchequer if employees could claim NICs refunds on expenses is the difference in the personal allowance for tax and the primary threshold for NICs as mentioned above.

4.29 The impact on contribution records would need to be understood, as well as those sectors where employees are not normally reimbursed but incur high levels of business expenses.

| | |
|---|--|
| <p>IT statutory reference: Part 5 ITEPA 2003</p> | <p>NICs statutory reference: Schedule 3 SI2001/1004</p> |
|---|--|

Box 4.D: Recommendation

We recommend that 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.

Aligning the tax bases – benefits in kind (BiKs)

There is misalignment in the treatment of benefits for IT and NICs, with the NICs rules causing more practical complexities

4.30 Subject to certain exemptions, all BiKs are liable to IT whether they fall within the tax definition of ‘earnings’ (ie represent money or money’s worth) or are benefits ‘treated as earnings’.

4.31 By contrast the class of NICs due and the subsequent liability depends on the form which the BiK takes. If the BiK is earnings within s3 SSCBA there is a liability to Class 1 NICs (eg retail vouchers). Class 1 NICs are payable by both the employee (primary) and the employer (secondary). If the BiK is not subject to Class 1 NICs under s3 SSCBA but is still ‘general earnings’ for tax under ITEPA 2003 (eg a company car) it is liable to Class 1A NICs under s10 SSCBA. Class 1A NICs are payable by the employer alone.

4.32 There is then an extra layer of complexity. It is not just the form of the benefit that determines whether it is subject to Class 1 or Class 1A NICs but also the contractual arrangements behind the sourcing of the benefits. (The contractual arrangements can also have different tax implications.)

These differences create distortions

Table 4.C: This table sets out the IT and NICs position when an employer rewards two employees in different ways

| | Employer provides TV at cost to the employer of £600 | Employer provides £600 cash |
|----------------------------|--|-----------------------------|
| Income Tax (at basic rate) | £120.00 | £120.00 |
| Employee NICs liability | nil | £72.00 |
| Employer NICs liability | £82.20 | £82.80 |
| Payment due | After the tax year | In the pay period |

Summary of views and evidence

4.33 This is not a new issue; it is one we highlighted in our 2013 Review of Employee Expenses and Benefits. At the time, concerns about the impact on employees who would pay more NICs, especially the less well off, if all BiKs were to subject to Class 1 NICs, were widely expressed. It is very noticeable now that although this is acknowledged as a factor, the almost universal view is that the current system is inequitable and creates unfairness, and that the NICs treatment should follow the IT treatment so that BiKs are liable to Class 1 NICs. An individual’s tax bill should not depend on the form their remuneration takes and the current system gives an advantage to those receiving benefits rather than cash pay.

4.34 The most frequent complaints we heard about BiKs were around the need to consider whether a contract for a supply of goods or services was with the employer or employee. It was felt this creates extra administration and contains a strong potential for error. Where the employee has contracted for the supply of goods or services, and the employer either meets the supplier's bill directly or gives the employee the funds to enable them to pay the bill, there is a liability to Class 1 NICs. Where by contrast the employer contracts with the supplier for goods or services to be made available to the employee the cost of the supply is a BiK liable to Class 1A NICs.

4.35 The matter is made even more complicated where the employee purchases (say) fuel for a business journey in a company car by means of a company credit card. In those circumstances liability depends upon whether or not the employee made clear to the service station before fuelling that he was making the purchase as agent for his employer – see *Richardson v Worrall* and the *Overdrive* case.^{3 4}

Ways of aligning the treatment of BiKs

4.36 In principle, all taxable BiKs should be brought into Class 1, and Class 1A NICs should be abolished. The only exception should be when a benefit is included in a PAYE settlement agreement (PSA), under which the employer will be paying tax on a grossed up basis and Class 1B NICs.

4.37 Approximately £1.1 billion of Class 1A NICs was paid by employers in respect of the year 2014-15. This translates into the provision of taxable benefits of approximately £7.9 billion. We understand that many of the employees in receipt of these benefits would have annual earnings above the upper earnings limit, and would only pay Class 1 NICs at 2% on their benefits, compared to employees below the upper earnings limit who would pay Class 1 NICs at 12%, based on current rates. Employers Class 1 primary NICs is charged at the same rate as Class 1A so there would be no direct change in the cost to employers. A broad assumption is that this change could give rise to additional receipts of approximately £435 million in Class 1 primary NICs.

4.38 It would clearly be possible, as the OTS noted in its earlier report, for the rate of employee NICs to be adjusted slightly to take account of the extra yield.

4.39 This alignment is contingent on transitioning to calculating NICs on an annual basis rather than using monthly or weekly earnings periods and the introduction of a code. Although it would be possible to have a system to charge Class 1 NICs on benefits without ACA, the processes necessary would be involved.

How would NICs be charged / collected on BiKs?

4.40 If benefits are payrolled, Class 1 follows easily⁵. Both employer and employee contributions on BiKs are then collected at the same time as those on pay.

4.41 In recommending payrolling be introduced, the OTS was very clear that the system had to be voluntary. We do not seek to change this principle and we do not make any recommendation to transition to mandatory payrolling of benefits which in any event is impractical.

³ [1985] STC 693; 58 TC 642

⁴ R v Department of Social Security ex p Overdrive Credit Card Ltd [1991] STC 129

⁵ During our Employee Benefits and Expenses review, we found some employers who were already payrolling some benefits – and applying Class 1!

4.42 If a benefit is not payrolled, Class 1 primary NICs would be collected via HMRC amending the employee's NICs code at the same time as they amend the employee's PAYE code, based on information on their form P11D.⁶ The employer's NICs charge (whether it is Class 1 secondary NICs or the alternative charge proposed in this report) would be calculated and collected on an annual basis in the same way as Class 1A.

4.43 The advantages of this alignment:

- employers - simplified administration and reduction in the possibility for error
- employees - parity in the NICs treatment of non-cash remuneration

4.44 The challenges of this alignment:

- for employees, there would be a NICs liability on BiKs where none had existed before. For modestly paid employees in receipt of expensive benefits such as a company car, there would be a noticeable difference in their take home pay. Potentially if there is an increase in the Class 1 NICs collected, the government would need to allow for more people being entitled to contributory benefits. The impact on the lower paid of aligning the treatment could be addressed through clear information and reasonable notice of the change so they can adjust
- a challenge of using a NICs code to collect Class 1 NICs on BiKs that are not payrolled is that initially NICs would be collected in the year after the tax year in which the BiK is provided. Consideration would also need to be given as to how to allocate the Class 1 NICs to the individuals' contributions records for the correct period

Box 4.E: Recommendation

We recommend that there should be a commitment to harmonising the NICs treatment of benefits in kind and cash rewards over a suitable period. The OTS notes that there will be a need to fully explore the impact on individuals, businesses, the exchequer and the administration of a move to alignment.

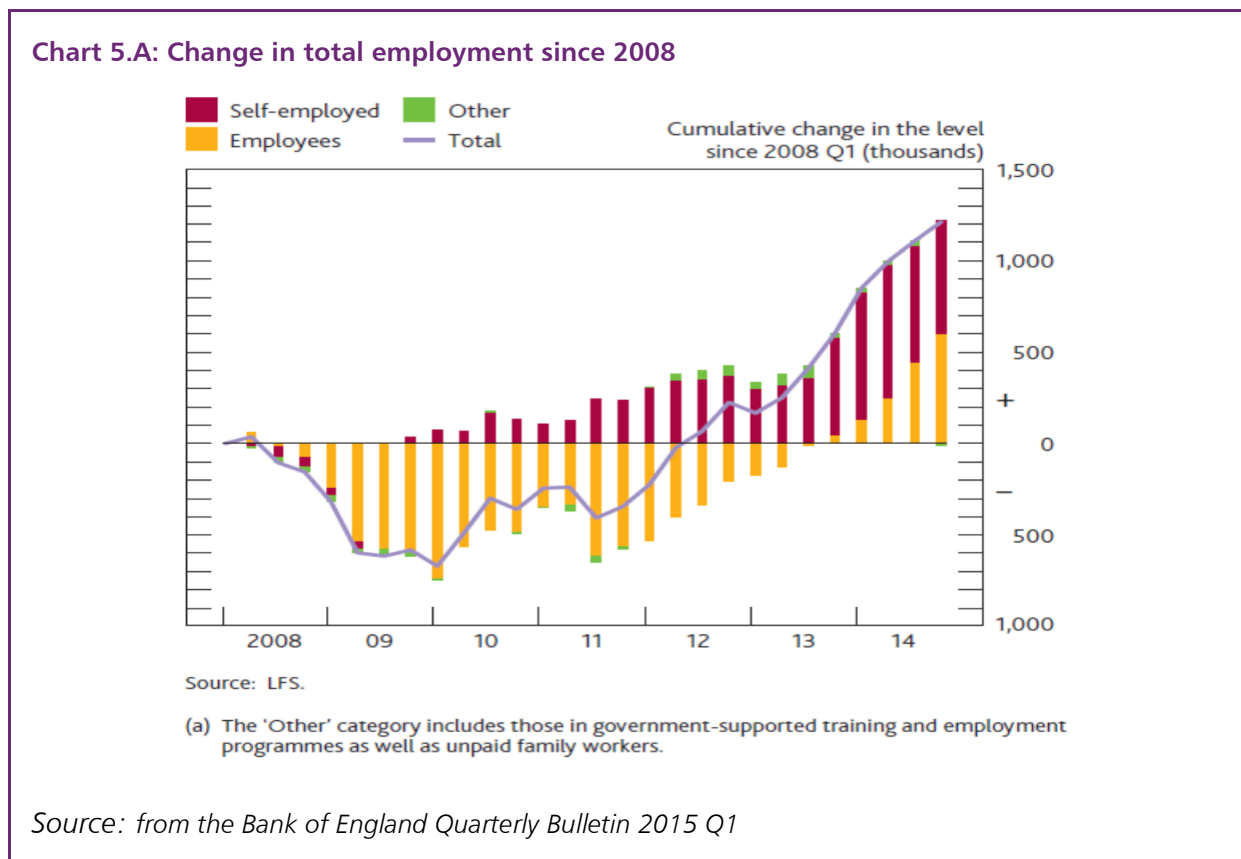
⁶ This assumes that the NICs are placed onto an ACA basis with a NICs code. If this is not done, collecting Class 1 primary NICs on non-payrolled benefits becomes much more difficult but not impossible: potentially an annual charge operated post-5 April by the employer. That runs into difficulties over people with more than one job and the operation of NICs thresholds which might lead to a decision to have a simple pragmatic rule and rate for NICs on such benefits.

5 Employed and self-employed

5.1 Recent OTS surveys and research reveal that many people find the distortions between employed and self-employed Income Tax (IT) and NICs to be confusing and opaque, and many taxpayers do not realise that self-employed people pay a lower rate of NICs and are also not entitled to all contributory benefits. This is seen by some to be unnecessarily complex, and inequitable.

5.2 This chapter focuses on the differences between IT and NICs for the self-employed, and also on the differences in the NICs position between the employed and the self-employed. This is discussed in more detail Chapter 12.

5.3 In 2013-14, 3.5 million people paid tax on self-employed income and 22.9 million paid tax on employment income.¹ In the first quarter of 2013, 4.2 million people were self-employed compared to 4.7 million in the last quarter of 2015.² The current level of self-employment reflects an on-going trend, illustrated in Chart 5.A.



¹ <https://www.gov.uk/government/statistics/earned-income-2010-to-2011> . Table 3.6 Profit, Employment and Pensions Income, 2013-14

² ONS Employees and self-employed by industry: EMP14
<http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/employeesandselfemployedbyindustryemp14>

The self-employed figures in these tables include those who engage through personal service companies

5.4 There is also the ‘third dimension’, concerning the form through which some workers are engaged. A self-employed worker may provide services directly or through an intermediary company, in which case the engager pays the limited company for providing services. Many self-employed people work through limited companies in order to limit their liability. Some workers provide their services through Managed Service Companies or Umbrella Companies. Some intermediary companies may be taxed under the provisions known as IR35 (which applies in situations where, if the intermediary did not exist, the relationship would constitute an employment relationship between the individual and the engager). Workers using intermediary companies may describe themselves as self-employed (reflecting their independence), even though the formal structure indicates that they are employees.

5.5 IR35 is outside the remit of this project and will not be discussed in any detail as it is currently subject to consultation by HMRC; previous OTS projects such as the Small Business Tax Review of March 2011 have already discussed IR35 in some detail.³

5.6 To allow for employed and self-employed IT and NICs alignment to be discussed in a reasonable degree of detail, it is necessary to consider how they each differ. One can then conclude whether any alignment between the two is possible, viable, and equitable.

Table 5.A: Current differences in the IT and NICs treatment of employed and self-employed individuals

| Employed individuals | Self-employed individuals | Different treatment |
|--|---|----------------------------|
| Income, including that of office-holders, is subject to PAYE / P11D and Class 1 NICs on the gross amount earned | Income is subject to IT and Classes 2 and 4 NICs on taxable profits | Yes |
| IT and NICs are generally collected per pay period by the employer and sent to HMRC under RTI | IT and NICs are payable twice yearly, in January and July through the Self-Assessment system | Yes |
| NICs paid at a rate of 12% up to £42,385 (2015-16) and 2% thereafter | NICs paid at a rate of 9% up to £42,385 (2015-16) and 2% thereafter | Yes |
| Start to pay NICs when earnings reach the Primary Threshold of £8,060pa (2015-16) and get a NICs credit on earnings between the Lower Earnings Limit and the Primary Threshold. | Start to pay Class 2 NICs immediately as they cross the low profits threshold of £5,965 and Class 4 NICs when their profits reach £8,060pa (2015-16) | Yes |
| Voluntary contributions can also be made if eligible | Voluntary contributions can be made if eligible, but at a different rate than for an employed person | Yes |
| Employers pay Class 1A or Class 1B NICs on Benefits-in-kind (both classes are 13.8%) but employees do not pay Class 1 NICs on benefits in kind | No employer NICs are due on self-employed income | Yes |
| Employers pay NICs on BiKs at Classes 1A and B (both classes are 13.8%) but employees do not pay Class 1 NICs on benefits in kind | NICs is paid on trading expenditure which benefits the trader directly | Yes |

³

www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf

| Employed individuals | Self-employed individuals | Different treatment |
|---|---|---------------------|
| Can claim an IT deduction on any expenses wholly, exclusively and necessarily incurred on business but do not qualify for a corresponding NICs deduction for non-reimbursed expenses ⁴ | Can claim an IT <u>and</u> NICs deduction on expenses wholly and exclusively incurred on business | Yes |
| Eligible to claim the full range of contribution-based benefits subject to their contributions record | Not eligible to claim some contribution-based welfare benefits (From April 2016 however, the only difference will be contribution-based JSA, as the self-employed will have the same state pension entitlements), and Voluntary NICs confer lower benefits entitlements than Class 2 does currently | Yes |
| Must instigate a refund claim to reclaim overpaid NICs | Can carry forward unused NICs losses to set against future trading profits. IT losses can be offset in the same year against other sources of income | n/a |

What if someone is employed and self-employed at the same time?

5.7 Where someone is employed and self-employed simultaneously, they must pay three kinds of NICs - Class 1, Class 2 and Class 4 – whereas for IT purposes, they are only required to pay one impost on all income, regardless of source. A person with more than one employed role also has to pay separate and distinct amounts of Class 1 NICs, subject to the annual maximum.

Summary of views on the differences and distortions:

- employees and the self-employed are generally unaware of the differences as set out above; those that are aware see the differences as inequitable and unnecessarily complex
- the self-employed feel they are being discriminated against due to the lack of access to the welfare benefits others can claim, such as JSA if their business fails
- there is split opinion amongst respondents as to whether the employed and self-employed should pay the same rate of NICs on their earnings and have access to the same welfare benefits
- the perspective of some is that employees pay more NICs but self-employed take more risks – so, it is reasonable that the self-employed pay less NICs
- the absence for the self-employed of an equivalent to employers' NICs for the employed is believed by some to be a driver for engagers to insist individuals contract as self-employed rather than join the payroll
- a small number of respondents suggested that 2 'tiers' of NICs should be applied across the board for all workers regardless of employment status. In such a scenario, Tier 1 would be a basic contribution of say 8% and entitlement to a state pension. Tier 2 would be a voluntary contribution of say 4% and entitlement to welfare benefits

⁴ ITEPA 2003, s. 336

Recent consultation

5.8 A joint HM Treasury, HMRC and DWP consultation has recently concluded examining how to abolish Class 2 NICs and reform Class 4 NICs to give benefit entitlements.⁵ As this will have significant implications for simplification, our recommendations below are in the context of the outcome of that consultation and are expressed in broad terms. We recommend that these and other reviews are brought together in a coherent manner.

Recommendations for further alignment

5.9 Following the current consultation, we recommend that further alignment of rates and thresholds between the employed and self-employed is explored. It should be noted however that detailed research and calculations will need to be completed to support any decision to pursue some or all of these recommendations.

5.10 The advantages of greater alignment would be:

- the self-employed would become eligible to receive welfare benefits they are not currently entitled to in return for a slightly higher NICs contribution
- the NICs position for both employed and self-employed will be simpler and easier to understand
- the self-employed will be encouraged to pay their taxes on an ongoing basis instead of twice a year, which will smooth both their and the exchequer's cash flow
- taxpayers will be able to use a simpler refunds application system and obtain refunds within a reasonable timescale
- more certainty that the drivers of self-employment are those of genuine entrepreneurial motivation and not contrived to avoid NICs

5.11 The challenges in achieving greater alignment would include:

- the self-employed will pay a slightly higher rate of NICs up to a certain level, and
- the exchequer will need to fund JSA for those self-employed workers eligible to claim

5.12 Alignment of employed and self-employed NICs would be contingent on the acceptance of wider alignment of IT with NICs. There would be no point in concentrating on this area as a stand-alone area for simplification. We think this is a longer term proposal that could be achieved in the next five years.

5.13 Subject to agreement by HMRC and DWP, these proposals would help make the general alignment of NICs and IT more possible, which would amount, over the longer term, to a simplification.

⁵ 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

Box 5.A: Recommendations

- 1 More closely align the NICs position for the UK's self-employed with that of employees, to remove complexity and potentially to converge benefits.
- 2 Ensure that what is liable to IT for the self-employed is also liable to NICs (impact on the employed is dealt with in other Chapters).
- 3 If it is not possible to align in these ways, a reason should be stated as to why this is not considered possible, whether at the present time or in the future.
- 4 Review whether the Categorisation of Earners Regulations⁶ remain appropriate (see Chapter 12). Publish and regularly update the policy justifications.
- 5 Remove the notion of 'Classes' of NICs and simply have four categories – Employees', Self-employed, Voluntary and Employers' to keep the language and the concepts easy for taxpayers to understand.
- 6 Greater flexibility for the self-employed to be able to make more frequent payments on account, through the Your Tax Account system. To note: an HMRC paper has been published on the concept of simpler payments⁷ as part of the Making Tax Digital series of papers.

Ongoing reviews

We recommend that the planned HMRC / HMT / DWP / BIS working group on employment status is expanded to include the OTS and also considers the position of the self-employed with a view to considering harmonising rules and procedures.

The OTS should also be formally involved with the group and the wider policy debate, to help drive policy solutions that simplify and better balance matters for the self-employed.

⁶ Social Security (Categorisation or Earners) Regs – SI 1978/1689

⁷ www.gov.uk/government/uploads/system/uploads/attachment_data/file/484808/Making_tax_digital_-_Discussion_paper_on_simpler_payments.pdf

Legislative and administrative alignments

6

Enhancing the legislative and administrative links between Income Tax (IT) and NICs, and within NICs

6.1 We have considered a number of areas to improve these links and reduce the complexity confronting taxpayers. We looked at guidance and administration, policy development, enforcement, rates and thresholds, and Parliamentary procedure for developing the core legislation. A more unified approach to IT and NICs legislation and administration will help to contain and reduce the number of differences between the two regimes.

6.2 In the course of our research we heard and made a number of observations on the above themes:

- there is little or no linkage between HMRC's IT and NICs guidance on the same items or issues. It would be better if the information on the two imposts could be found in the same place. We were told that frequently employers find the NICs position complex and confusing, and search results on Gov.UK should bring up the relevant NICs guidance not just the IT guidance. AMAPs are a perfect example of where the IT and NICs guidance is separate and unlinked. A search on Gov.UK using 'business mileage' does not bring up the relevant NICs guidance.
- some changes to NICs legislation seem to trail behind IT legislative changes and often appear as an afterthought even if they have been considered throughout the policy and consultation process. For example a new trivial benefits exemption that will be introduced by Finance Bill 2016 is due to come into effect from 6 April 2016. The exemption extends to non-cash vouchers. The changes to the NICs legislation by statutory instrument will not take effect until the instrument is laid which will be after the Finance Bill receives Royal Assent¹.
- NICs legislation is generally not enacted by way of Finance Bills but in separate NICs legislation, making aligned amendments more difficult. See the further discussion at Chapter 13.

6.3 The above observations may contribute to an external perception that HMRC NICs and IT staff appear to work in silos. The routes for customers to resolve issues by phone or online using published guidance reinforce this perception. There is also a perception that HMRC does not proactively engage with advisers on NICs operational issues, but will readily engage on specific new policy areas or where the law is unclear.

6.4 We understand that HMRC has plans to bring the employment income and NICs technical teams closer together and we have been advised that policy teams do work collaboratively, although this may not always be visible to taxpayer groups. We also recognise that HMRC has published plans to move towards multi-channel digital services for taxpayers, which is intended to ensure that current customer service issues generated by traditional telephony and paper engagement diminish over time. The challenge is to ensure that the IT and NICs customer

¹ www.gov.uk/government/publications/tax-exemption-for-trivial-benefits-in-kind-draft-guidance

service becomes fully coordinated. OTS are engaged in this transformation process to ensure that tax simplification remains a key design objective.

Recommendations

6.5 Our recommendations are in Box 6.A. These could be acted upon regardless of the decisions made on other recommendations in this report and work to implement them could start immediately.

Box 6.A: Recommendations

Administration and policy development

1. Pages in the guidance that deal with an issue from an IT position should be linked to the equivalent NICs guidance and there should be links from the NICs guidance to the IT guidance.
2. Policy outcomes need to demonstrate that there has been an IT and NICs collaboration to achieve where possible greater alignment between the two, and Tax Information and Impact Notes (TIINs) should show whether both IT and NICs implications have been considered.
3. Amend NICs legislation by cross referring to IT provisions, or provide an explanation in instances where this is not possible. (See Chapter 13 for constitutional limits to changing NICs in IT legislation).
4. HMRC needs to raise awareness of both IT and NICs in customer-facing staff and, as it moves to multi-channel digital services for customers, there must be an assurance that the IT and NICs implications of issues are presented together.
5. Review the NICs refunds mechanism for individuals to ensure it is easy, timely and reasonable and with a view to simplification.

Taxpayer groups would welcome increased engagement on NICs policy and operational matters, for example at stakeholder forums, in particular dialogue on issues that are causing employers difficulty.

Enforcement – establishing the charge

Current differences between IT and NICs charge

6.6 IT - on discovering that tax has been, or may have been, undercharged HMRC may, subject to certain taxpayer safeguards, make an assessment to correct the undercharge.

6.7 NICs - HMRC can correct an apparent underpayment of Class 4 NICs in the same way as it can correct an apparent undercharge of IT. On the other hand, where there is an apparent underpayment of Class 1 NICs HMRC has to make a Decision that quantifies the underpayment if there is a dispute and notify the Decision to the Employer or Engager. The Decision does not protect HMRC's right to the NICs due or under dispute. Protection of the charge can only be secured by lodging a Protective Claim in the appropriate Court.

6.8 However, we received no representations on these differences.

Examples of distortions

6.9 The differences in procedure set out above illustrate the distortions. The fact that the procedure for establishing and protecting a claim to underpaid Class 1 NICs is relatively so complex must carry the risk of a loss of revenue.

Ways of aligning the charge

6.10 Reproduce the IT discovery assessment provisions for unpaid Class 1 NICs, with any necessary modifications. This would achieve greater simplicity and certainty of recovery, with no foreseeable disadvantages. This alignment is not contingent on any other alignment, changes or factors and could be achieved within a year.

| | |
|---|---|
| IT statutory reference: Section 29 TMA 1970 | NICs statutory reference: Section 8(1) Social Security (Transfer of Functions) Act 1999 |
|---|---|

Enforcement – time limits

Current differences

6.11 IT - in England, Wales and Northern Ireland IT is a crown debt. There are no time limits for the recovery of a crown debt. In Scotland there is a time limit of 20 years.

6.12 NICs constitute a civil debt. In England, Wales and Northern Ireland action for recovery must be commenced within 6 years from the due date of payment. In Scotland the time limit is 20 years from the due date of payment.

6.13 However, we received no representations on the differences.

Examples of distortions created by these differences

6.14 The differences in time limits set out above illustrate the distortion. This, coupled with the differences in procedures for establishing charges to unpaid tax and NICs, must carry the risk of a loss of revenue.

Ways of aligning the time limits

6.15 Amend the legislation so that the time limits for recovery of a NICs debt are aligned with those for recovery of an IT debt thus producing unified time limits in each part of the UK.

6.16 This would achieve greater simplicity and certainty of recovery, with no foreseeable disadvantages. This alignment is not contingent on any other alignment, changes or factors and could be achieved within a year.

Rates and thresholds

What's the problem?

6.17 Taxpayers and employers are faced with a mass of rates and thresholds (see Annex F). The two examples cited to us most often vary widely in impact² - while the value to the exchequer of the difference in 2015-16 between the IT personal allowance (£10,600 pa) and the NICs primary

² Both the estimates are based on HMRC "Direct effects of illustrative tax changes" for 2016-17, www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes

threshold (£8,060 pa) is around £6.5 billion, the value to the exchequer of the difference between the NICs primary threshold and the NICs secondary threshold (£8,112 pa) is around £130 million. It is not long since both these pairs of thresholds were aligned.

6.18 New thresholds continue to be introduced, rather than use existing thresholds. For example an Apprentice Upper Secondary Threshold (AUST) will apply from 6 April 2016. While initially this will be at the same level as the long established Upper Earnings Limit (UEL) it has 'been deliberately framed to keep the definitions separate so that the AUST, and UEL and the age-related secondary **rate may be changed independently in future.**'³ (Our emphasis added.)

6.19 While recognising that setting each threshold is a policy issue, **we recommend that:**

- new thresholds are not introduced in circumstances where existing ones can serve the same purpose
- existing thresholds are reviewed to establish which may be aligned (and then remain linked) in a given timeframe. Aligning the NICs primary and secondary thresholds is a good place to start

6.20 These changes are not contingent on any other alignment, changes or factors, but will make further alignments easier. We think that a decision in principle to align could be taken quickly but the programme of convergence would take time. We fully recognise that re-aligning the main IT personal allowance and NICs threshold would have significant revenue implications, which may preclude change but does not invalidate our simplification point.

NICs legislation

6.21 It is well known that NICs cannot be changed in a Finance Bill but separate Social Security legislation has to be used. There are limited exceptions to this rule but it led us to research the question 'Why?'. As the system stands, it:

- is inefficient (elements of double the work as two sets of rule changes have to be made, including more Parliamentary time)
- leads to possible inconsistencies
- can mean differing start dates⁴

6.22 Our researches⁵ show that the main reason for the differing routes is Parliamentary convention. This would be difficult to change, but we think it is important that a route is found so that IT and NICs changes can in effect be simultaneous with a single provision. It would, we think, be possible to change NICs legislation in such a way that future IT changes automatically apply to NICs. Chapter 13 gives our full analysis.

³ Tolley's National Insurance Contributions 2015-2016

⁴ A current example is the rule changes coming in from April 2016 regarding exemption a trivial benefit from income tax – but the NICs changes will happen later in the year.

⁵ We are grateful to the Office of Parliamentary Counsel for their assistance in this work.

Box 6.B: Recommendations

Enforcement

1. Reproduce the IT discovery assessment provisions for unpaid Class 1 NICs, with any necessary modifications.
2. Amend the legislation so that the time limits for recovery of a NICs debt are aligned with those for recovery of an income tax debt thus producing unified time limits in each part of the UK. Simplify the refunds mechanism for NICs to ensure it is easy, timely and reasonable.

Rates and thresholds

3. New thresholds should not be introduced in circumstances where existing ones can serve the same purpose.
4. Existing thresholds should be reviewed to establish which may be aligned (and then remain linked) in a given timeframe. Aligning the NICs primary and secondary thresholds is a good place to start.

Legislation

5. Change NICs legislation in such a way that future Income tax changes automatically apply to NICs.

7 A snapshot of views

These are not all direct quotes, but a sample of the most frequent comments and observations we heard in conversation with stakeholders. A list of who we met can be found at Annex D; these comments represent typical views in each area.

On transparency and the contributory principle ...

... the average individual thinks NICs secures certain rights, but is not clear what those rights are...

... we get few questions from employees about NICs - they accept what is deducted. PAYE income tax is a well understood conversation, and any fluctuating amounts will be challenged; NICs generally isn't ...

... many people do not realise there are contribution-based and income-based benefits, or there is a difference between these benefits ...

... no broad understanding of the contributory principle...a lot of support for it, but that does not translate into an understanding of how it works...

...the contributory principle is not just an abstract principle. It has a real impact on what people are entitled to and when ...

On changing the structure of employees' NICs ...

... the low paid would pay more, but this would not be an issue if it was clear it was in their long term interest...the rules do not reflect modern flexible work patterns ...

...should NICs operate in the same way as PAYE? Scepticism as to whether the change is worthwhile (there must be cost savings) but it would certainly give fairer outcomes...

...concerns would be the accuracy of codes and reconciliations from HMRC, and enough time to develop and embed software...

...annual / alignment may not make processing easier but it would make explanations and understanding of IT / NICs easier...

On employers' NICs ...

... just a payroll tax – call it what it is and stop pretending it has anything to do with NI, or the employee's contributions ...

... having only Class 1 on benefits etc. would be a simplification ...

... employees have no understanding of employer NICs - re-naming it would improve understanding and transparency (for example, "employers' social contribution") ...

On alignment of definitions and bases ...

... it would help if there were common definitions. Ideally there should be an exact mirror, aligning on the current IT rules ...

... anything received as pay or reward should go through payroll and be liable to NICs. Overall, there should be the same income tax and NICs consequences no matter how the money/benefit is provided...

... aligning the legislation would harmonise the administration, collection and compliance, with savings that enable HMRC to resource other areas ...

... earnings differences, thresholds and bands are at the top of the wish list; they cause confusion and complexity ...

On the self-employed ...

... there is merit in the difference, because of the degree of risk, but there must be a safety net ...

... they (the self-employed) should pay the same and get the same ...

On planning opportunities created by IT / NICs differences ...

... some employers award work on terms of engagement that purposefully achieves a different NICs outcome ...

...it's not just about NICs, it's all the employers' red tape – single biggest admin burden is taking on your first employee...

... remove the major unfairness across pension contributions...

...different outcomes create tax driven business decisions about reward and workforce, and it would be a simplification to remove them...

On the administrative burden and complexity of IT / NICs ...

... there are many hidden costs in maintaining the mass of legislation around NI. Civil servants, employers and charities spend a lot of time assimilating and re-writing it in understandable terms ...

... if it's simple enough to do, business will do things themselves; the costs of compliance are down to lack of knowledge and requiring agents and consultants to do things for them ...

... NICs legislation is obscure and difficult to follow; putting it within a Finance Act would make it (almost) certain that IT and NICs rules are changed in parallel (or would be clearer when they weren't)...a demonstrable commitment to simplification ...

... HMRC's guidance is not keeping up with changes in working patterns, especially international working...employers won't ask HMRC as it takes too long to get an answer; also, it takes a long time to secure a refund ...

Discussion: transparency and the contributory principle

8

Introduction

8.1 This discussion addresses concerns about the transparency of NICs for taxpayers. These are in part related to the role of NICs in benefits, the notion and reality of the contributory principle and the existence of the National Insurance Fund (NIF). A high level overview of these is given. Some of the issues are connected with the long history of NICs and changes in its key features over that time. These are well documented elsewhere.¹

8.2 Transparency is an important element of a simpler tax regime because it enables taxpayers to understand and comply with their obligations, and challenge their liabilities as appropriate. For NICs, transparency has a further role in helping individuals understand and build social security entitlements.

8.3 At its simplest the contributory principle is the idea that social security benefits are entitlements gained by making contributions, combining aspects of reciprocity (that something paid leads to a benefit) with solidarity (that the return is not precisely linked to the payment). This is broadened in the UK by the role of NICs in partially contributing to the costs of the NHS. The government's commitment to the contributory principle has frequently been stated.²

8.4 Many have said that the contributory principle is obsolete, but many firmly support its retention (and some call for it to be enhanced). Pure simplification principles would probably indicate abolition but we do not see a clear mandate for that course and it would be a major change to the UK tax system. But if the contributory principle is to remain, we think it must be made to work and seen to work.

8.5 Accordingly, although we recommend improvements to the transparency of NICs, these, and other simplifications recommended in this report, do not entail any changes to the contributory principle as such or changes to the NIF. Our general conclusion is that retaining the contributory principle should bring with it improved transparency to validate the system.

NICs and benefits

8.6 The UK regime for state benefits is complex. The summary below seeks only to outline the relationship with NICs as background for identifying some of the confusion which surrounds the role of NICs.

¹ See, for example, *National Insurance Contributions: an introduction*, House of Commons Library Briefing Note: www.researchbriefings.parliament.uk/ResearchBriefing/Summary/SN04517

² Most recently in the consultation on the abolition of Class 2 NI issued in December 2015, 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

8.7 The NICs regime impacts benefits in various ways, by:

- directly linking the entitlement to certain benefits to an individual’s NICs contributions (‘contributory benefits’),³ and
- providing the regulatory framework (‘NICs regulated benefits’), for:
 - certain statutory payments (or ‘statutory benefits’), including the proportion of such payments which can be recovered from HMRC, such as statutory maternity pay and statutory sick pay
 - a non-contributory, non-statutory benefit – certain maternity allowances

8.8 NICs (including Employers’ NICs) are paid to HMRC and contribute to the NIF. Some benefits are paid from that fund (see Chart 8.A). In contrast, the cash flow for statutory payments is directly from the employer to the employee, the employer taking reimbursement by netting against the employer’s PAYE / NICs payment to HMRC.⁴ Statutory payments offset against an employer’s PAYE / NICs payment are ultimately borne by general taxation so a compensatory transfer is required from the consolidated fund to the NIF (illustrated in the Chart 8.A).

8.9 In addition to contributory benefits and statutory benefits there are others, mostly means-tested and not addressed here, which are not linked in any way to the NICs structure. None of the benefits linked with NICs will be replaced by Universal Credit.

A summary of the link between NICs, contributory benefits and NICs regulated benefits

Table 8.A: Abbreviations used in the following sections

| | | | |
|------|--------------------------------------|-----|---------------------------|
| AUST | Apprentice upper secondary threshold | SE | Self-employed |
| LEL | Lower earnings limit | SPA | State pension age |
| NIF | National insurance fund | UST | Upper secondary threshold |
| PT | Primary threshold | | |

³ Bereavement Payment is contingent on the NI contribution record of the deceased spouse/civil partner.
⁴ For statutory payments (other than SSP since 6/4/14), ie SMP, SAP, SPP, part of the payments to individuals can be recovered by offset against NICs due, by reference to the total gross NICs paid in the complete tax year preceding the employee’s trigger week: 100% if gross NICs ≤ £45k, otherwise 92%.

8.10 The sequence described below is a high level summary only.

- 1 To establish whether an individual / employer is liable or eligible for paying NICs (Class 3A ignored), apply age tests according to Table 8.B below.⁵

Table 8.B: This table sets out an individual's NICs liability depending on their age.

The purple coloured boxes indicate where there is no liability / eligibility, and the non-coloured boxes where there is liability/eligibility.

| Age | Class 1 primary | Class 1 secondary, 1A, 1B | Class 2 | Class 3 voluntary | Class 4 |
|------------|-----------------|--|---------|----------------------------------|--------------|
| <16 | | | | | < 16 at 6/4 |
| 16 to <21 | | (0% to UST for CI 1s only) | | (Some exclusions for ages 17/18) | |
| 21 to <SPA | | (0% to AUST for CI 1s only for apprentices) ⁶ | | | |
| ≥SPA | | | | | ≥ SPA at 6/4 |

- 2 To earnings, then apply the relevant thresholds and rates, to calculate NICs due, and paid.
- 3 If earnings are between the LEL and PT, NICs are deemed paid.
- 4 NICs credits are allocated to an individual in certain circumstances, generally for periods in which specified benefits are claimed or NICs cannot be paid (eg periods of Statutory Maternity Pay, jury service, service families overseas). Credits do not have identical consequences to paid NICs (see table below).
- 5 Earnings factors are applied to the results of steps 2, 3 and 4 (in effect grossing up), and the outcome is used to...
- 6 ...apply contribution tests which are a necessary, but not sufficient, determinant of certain benefit entitlements.⁷ Class 1 secondary, Class 1A, Class 1B and Class 4 give no entitlements.⁸ Contribution tests are summarised in Table 8.C.
- 7 Benefits may have further tax and benefit ramifications:
 - Some NIF funded benefits trigger 'passported' benefits.
 - Some benefits trigger NICs credits.
 - Some benefits count as income for the purposes of means-tested benefits and or tax credits.
 - Some benefits are subject to IT.

⁵ Class 3A is a temporary voluntary contribution which can be paid by those who reach the State Pension Age (SPA) before the new State Pension is introduced in April 2016.

⁶ From April 2017

⁷ Other conditions vary according to the benefit and may include, for example, residence and presence.

⁸ A consultation has recently closed concerning the future of Class 2 and Class 4 and potential changes to benefit entitlements for the self-employed.

NICs based tests and benefit entitlements, highly simplified

Table 8.C: Benefits funded by NIF (Y = NICs payment leads to benefit entitlement)

| NICs: | Class 1 | Class 2 | Class 3 |
|--|--|----------------|---------|
| New State Pension ¹ | Y | Y | Y |
| NICs Tests | NICs paid or credited to produce earnings factor of at least 52xLEL in 35 years, reduced pension for fewer years, 10 years minimum | | |
| Contributory Job Seekers Allowance (CJSA) | Y | N ² | N |
| NICs Tests | Both: NICs paid to produce earnings factor of at least 26xLEL in 1 of 2 last tax years before the current benefit year, and NICs paid or credited to produce earnings factor of at least 50xLEL in both of those tax years | | |
| Contributory Employment Support and Allowance (CESA) | Y | Y | N |
| NICs Tests | Both: NICs paid to produce earnings factor of at least 26xLEL in 1 of 2 last tax years before the current benefit year, and NICs paid or credited to produce earnings factor of at least 50*LEL in both of those tax years | | |

¹ For those reaching State Pension Age (SPA) from 6/4/16

² Share Fishermen and Volunteer Development Workers are eligible for CJSA, paying a special rate of Class 2

| NICs: | Class 1 | Class 2 | Class 3 |
|--|--|---------|---------|
| Bereavement Payment | Y | Y | Y |
| NICs Test | In any 1 tax year, late spouse / civil partner NICs paid to produce earnings factor of at least 25xLEL (or 25 flat contributions pre 6/4/1975) | | |
| Bereavement Allowance and Widowed Parent's Allowance | Y | Y | Y |
| NICs Tests | <p>Both conditions have to be satisfied</p> <p>Condition 1</p> <p>Late spouse/civil partner must either:</p> <ul style="list-style-type: none"> • have had one qualifying year since 6 April 1975 of paid contributions • or have paid 50 flat-rate contributions at any time before 6 April 1975 <p>Condition 2</p> <p>For the standard basic rate (100 per cent) the late spouse/civil partner must have had qualifying years for about 90 per cent of the years in their working life. If they had fewer qualifying years than the number needed for the standard basic rate a smaller basic rate will be paid, provided that the number of their qualifying years was at least a quarter of the number needed. Qualifying years for this condition can be made up of paid contributions or credits or a mixture of paid contributions and credits.</p> | | |

Table 8.D: Benefits not funded by NIF (Y = NICs payment leads to benefit entitlement)

| NICs: | Class 1 | Class 2 | Class 3 |
|--|---|---------|---------|
| Statutory Maternity Pay (SMP)³ | Y | N | N |
| Not based on NICs record | <p>Various specific and general conditions, two general conditions relate to the NICs framework:</p> <ul style="list-style-type: none"> i Continuous employment. Employed by employer for a continuous period \geq 26 weeks up to and including the 15th week before the week the baby is due. Employer is an employer liable to pay CI 1 NICs (or would have been if a) earnings higher or b) employee had been \geq 16 years old). ii Earnings. Average weekly earnings in relevant period \geq LEL | | |
| Statutory Sick Pay (SSP) | Y | N | N |
| <p>No age limits</p> <p>Must be incapable of work for 4 or more days</p> <p>Not based on NICs record</p> | <p>Various conditions, one general condition relates to the NICs framework:</p> <p>average gross earnings over the 8 week period before sickness must \geq LEL</p> | | |

Also, if an employer is insolvent an employee can claim redundancy, unpaid wages and unpaid holiday pay from the NIF.

³ Associated rules for other statutory payments are not illustrated here (paternity pay, adoption pay, shared parental pay)

National Insurance Fund (NIF)¹

8.11 The existence of a separate fund is an integral aspect of the NICs regime. However, two features outlined below, the NHS allocation and the underpinning of the NIF from general taxation, mean that the overall practical impact of the NIF is less significant than at first appears (other than in relation to international treaties – see below). One research body has described it simply as “an accounting curio”.² How tax is accounted for could be regarded as beyond the concerns of tax simplification - unless it contributes to taxpayers’ confusion about a tax. This part briefly outlines the operation of the fund.

8.12 NICs paid by employees, employers and the self-employed are allocated to the NIF after deduction of that portion (currently about 20% overall) which is earmarked as a contribution to funding the NHS.³ NICs sourced funding for the NHS is about 20% of the total costs of the NHS.

8.13 Benefits funded by the NIF are paid from current contributions, not from previously accumulated funds. The rather idiosyncratic result is simply illustrated by the fact that in 2014-15 the brought forward balance in the fund was £23 billion, current employees and their employers paid in £84 billion, and £86 billion (94% of benefits paid from the NIF) was paid to pensioners (who do not pay NICs).⁴

8.14 As the NIF is established by statute, separate accounts are prepared by HMRC. The Government Actuary delivers reports on the ability of the fund to meet the commitments implied by current benefit entitlements and illustrates the impact of different contribution scenarios.

8.15 A further key feature of the NIF is that, following a recommendation by the Government Actuary in 1992, the ability to meet current benefit commitments is underpinned by grants from the Consolidated Fund (itself funded by general taxation). These grants seek to maintain the NIF at a level sufficient to meet two months commitments (expressed as 16.7% of forecast commitments).⁵ In 2014-15 such a transfer was made for the first time in a substantial sum (£4.6 billion) since 1997-98.

8.16 Another aspect of the NIF is its significant role in relation to the UK’s international social security obligations and agreements, as the existence of the NIF enables access to the advantages of such agreements.⁶

8.17 The major flows in and out of the NIF are illustrated in Chart 8.A.⁷

¹ Northern Ireland has a separate National Insurance Fund, which operates in a similar manner to the Great Britain fund, topped up from the GB fund as necessary to maintain the NI fund at 2.87% of the combined funds.

² *NICs: The end should be nigh*, Michael Johnson, Centre for Policy Studies 2015
www.cps.org.uk/publications/reports/nics-the-end-should-be-nigh/

³ Social Security Administration Act 1992 section 162

⁴ *National Insurance Fund Account for the year ended 31 March 2015* HMRC 2015
www.gov.uk/government/publications/national-insurance-fund-accounts

⁵ Social Security Act 1993 section 2

⁶ For example, in relation to EU obligations contained in the Social Security Coordination Regulations these apply where legislation enacts a tax or levy (however it is named) that contributes directly or dominantly to the financing of social security. There is no requirement for a contribution to determine entitlement to a social security benefit; however, if a contribution does determine entitlement this may also indicate a direct and sufficiently relevant link. There are therefore arguments that abolishing the NIF and moving NICs into the CF would not come within the scope of the Coordinating Regulations (as NICs would no longer directly contribute to the financing of social security, but would be a compulsory tax going to fund general public expenditure).

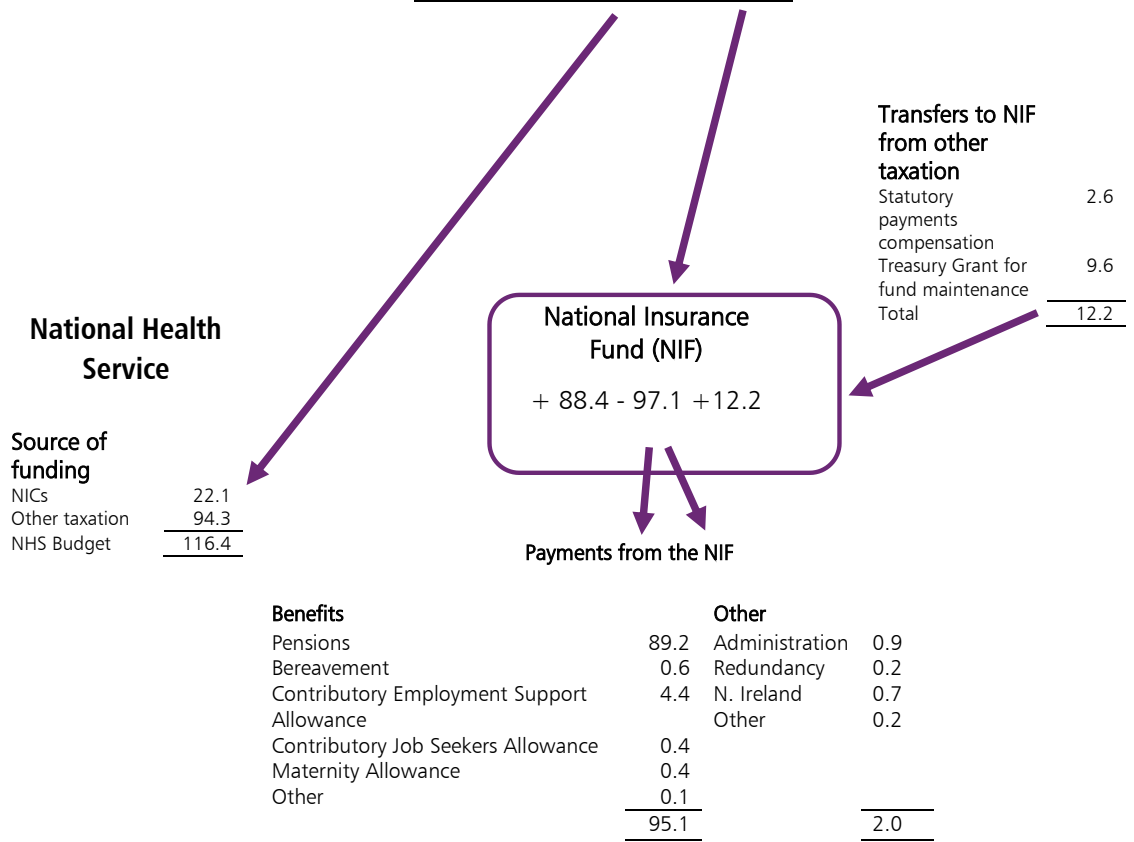
⁷ Based on Report by the Government Actuary, 1/2016,
www.gov.uk/government/uploads/system/uploads/attachment_data/file/494930/53430_GA_UpRating_Report_2016_Accessible.pdf, and www.gov.uk/government/news/department-of-healths-settlement-at-the-spending-review-2015

Chart 8.A: NICs and the National Insurance Fund (NIF). Estimated major cash flows 2015-16, £billion.

National Insurance Contributions

| | Source | Total NICs collected by HMRC | Paid to the NHS | Paid to the NIF |
|-------------------|---------------|------------------------------|-----------------|-----------------|
| Class 1 Primary | Employees | 44.7 | 8.7 | 36.0 |
| Class 2 Secondary | Employers | 63.5 | 12.4 | 51.1 |
| Class 1A & 1B | Employers | 1.3 | 0.2 | 1.1 |
| Class 2 | Self employed | 0.4 | 0.0 | 0.4 |
| Class 3 & 3A | Voluntary | 0.5 | 0.1 | 0.4 |
| Class 4 | Self employed | 2.6 | 0.7 | 1.9 |
| | | <u>113.0</u> | <u>22.1</u> | <u>90.9</u> |
| | | (2.5) | 0 | (2.5) |
| | | <u>110.5</u> | <u>22.1</u> | <u>88.4</u> |

Statutory Payments offset



Source: Based on Report by the Government Actuary, 1/2016, and www.gov.uk/government/news/department-of-healths-settlement-at-the-spending-review-2015

NICs, the NIF, benefits and complexity

8.18 It is not surprising that the interplay of the two already complex regimes of NICs and benefits encourages confusion and misconceptions. Some of these are set out below:

- 'National Insurance Contributions' implies an actuarial link between contributions and benefits, either overall or individually, but there has never been an individual link. The 'value' of an individual's contribution in terms of potential benefits is not linked to the NICs paid, there is no individual fund
- other benefits operate alongside contributory benefits. There is a lack of understanding of the difference between the two (though recipients are likely to have a good understanding)
- contributory benefits as a proportion of total benefits have declined over decades, also helping to erode the understanding of the relationship between NICs and benefits
- failure to meet the contribution tests for some contributory benefits may in part be compensated by access to means tested benefits
- the tax year runs 6 April 00 to 5 April 01. As contributory benefits in part are based on NICs paid in the previous tax year, the benefit year is different and runs 1st Sunday in January 00 to the day before 1st Sunday in January 01
- paid contributions (including deemed paid contributions) and credited contributions sometimes have the same consequence, but not always
- a change in income status potentially has to be reported to three agencies - HMRC, DWP and the local council

8.19 Representations to the OTS have pointed out a number stress points at which the contribution mechanism links with benefit entitlements,⁸ for example:

- if the state pension stops accruing after 35 years why should Class 1 primary NICs continue to be due?
- some regard the employer's liability to Class 1 secondary (and Classes 1A and 1B) beyond SPA as unbalanced given that the employee's Class 1 primary liability stops at SPA
- multiple low paid jobs paying in aggregate the same as a single higher paid job may lead to a different benefit entitlement. This will have a particular impact on the low paid
- eligibility for contributory job seekers allowance (CJSA) requires a good NICs record in the last 2 years, but ignores earlier years. It is possible to:
 - pay NICs for 30 years but not in 2 recent years and fail to get CJSA; or
 - make no contribution for 30 years, make 2 years' contributions and receive CJSA

⁸ Some disjointed parts of the benefit system were also pointed out, for example in some circumstances credited contributions may be switched from a wife to a house-husband, but this is poorly understood and so potential benefits foregone.

- if on investigation an employer is required to re-categorise a self-employed individual as employed and pay backlog Class 1, there is a perception that the employee's NICs record is not adjusted, despite HMRC guidance that an adjustment should be made

Conclusion

8.20 Fortunately it is not necessary for us to reconcile the very varied views expressed to us, from “the fund is a figment of the imagination” to “the contributory principle is not just an abstract principle. It has real impact...”. Our interest is whether the contributory principle (however people think that is manifested) and the NIF are complexities which impact on the delivery of a simpler tax system - with the backdrop that IT and NICs continue as two separate taxes. The context of our recommendations on the alignment of IT with NICs is that the NIF exists and a notion of contribution is integral to the fund, both in the reality of NICs paid in and in the entitlement tests which determine benefits. We do not consider that the fund or the contributory link inhibits the alignment of IT and NICs and none of our recommendations assume any change to these.

8.21 However, in taking forward the recommendations made elsewhere in this report there is an opportunity also to raise the level of understanding about the operation of NICs and indeed what NICs are for, and we start with two suggestions:

Contributory principle

Changes to NICs recommended elsewhere in this report will give opportunities to increase the understanding of taxpayers about what the contributory principle is.

Online tax account

At an individual and practical level understanding of NICs would be raised 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 online account will shortly show the build-up of entitlements to the new state pension. Although there are some problems with extending this to cover entitlement to other contributory benefits we recommend that the potential for this is reviewed so that taxpayers are better informed, but not misled.

8.22 One issue serves as an example both of the legacy of previous changes to NICs and of how NICs fits with the broader concept of the contributory principle.

NICs and earnings of those over state pension age (SPA) – the age exception and the earnings rule.

8.23 An employed earner who attains state pensionable age (SPA) is excepted from liability to Class 1 primary contributions on any earnings after that date (s6(3) SSCBA 1992).⁹ This has been the case since the introduction of NICs in 1948.

8.24 However, this was balanced by a corollary from 1948 to 1989 - the Earnings Rule. Briefly, this provided that where an individual had earnings above a certain limit the Basic State Pension was progressively reduced. The Earnings Rule was aimed at reducing the pensions bill for the

⁹ In full, s6(3) and s11(7)(b) SSCBA 1992; Reg 91SI2001/1004

government, on the basis that those working and with reasonable incomes did not need to claim the State Pension. This was detrimental to the work incentives of individuals aged over the SPA, and many left work simply in order to be able to claim their pension. It also contributed to pensioner poverty by limiting the income of pensioners who may have been prepared to do paid work in order to increase their incomes. Accordingly the Earnings Rule was abolished in 1989.

8.25 The result is that the age exception for NICs remains, without the balance of the earnings rule. Employers' secondary contributions continue without regard to SPA.

8.26 There are comparable exceptions for Class 2 and Class 4 NICs, though currently with different timing of the SPA exception.

Pensioners and working trends

8.27 In 2012-13 there were 5.9 million taxpayers over state pension age; of these 1.3 million received employment income and 0.4 million received self-employment income.¹⁰ A report published by the ONS in 2012 indicated that

“The number of older workers, defined here as those working beyond State Pension Age (SPA), has almost doubled from 753,000 in 1993 to 1.4 million in 2011. Over the period, the numbers remained relatively flat between 1993 and 2000 but quickly rose to a peak of 1.45 million in 2010.

..... looking at the percentage of the older population in employment this too has increased from 7.6 per cent in 1993 to 12.0 per cent in 2011. This shows that the number of workers above SPA has risen at a faster rate than the population.”¹¹

8.28 In short, more people are working past the normal retirement age, whether from choice or necessity. With increased life expectancy this is to be expected and as the retirement age increases, and life expectancy continues to increase, it is a trend likely to continue.

Discussion - can the age exception be justified?¹²

8.29 When we raised in a few meetings the issue of the age exception, comments predictably fell into two camps:

- why should people continue to pay NICs when they cannot accrue a greater state pension?
- as NICs are a general levy, there is no reason to continue this exception which will be increasingly illogical as working trends continue to develop

8.30 It might be argued that the contributory principle requires that liability to NICs should cease once the individual has reached the SPA, but the contributory principle is a broader concept than matching what is paid in with what is paid out. NICs are a contribution to wider pension liabilities, not just the individual's. This is reflected in the current pension rules - from April 2016 a male school leaver entering work and working to SPA pays in for 14 more years than needed to reach the maximum State Pension.

8.31 There is also the fact that 20% of NICs are allocated to the NHS, not the NIF. Those who are above the SPA are major users of the NHS.

¹⁰ HMRC Survey of Personal Incomes 2012-13, Table 3.12.

¹¹ ONS, Older Workers in the Labour Market, 2012

¹² Arguably, similar points could be made about the exception for the employment income of those aged under 16.

8.32 Different treatment gives rise to a fairness argument. If someone continues to work and earn from their activities, why should they pay less in tax (given that NICs are to all intents and purposes a tax) than someone else, just because of their age? Fairness would seem to argue that such individuals should have the same liability to NICs as people doing the same jobs who have not attained the SPA.

8.33 Clearly, if the age exception were to be removed, it would mean a cadre of older workers would pay more in taxation. However, there are a number of potential balances:

- the Primary Threshold will continue to provide a measure of relief for those in modestly paid jobs or on short period or part-time assignments. This is particularly the case if NICs are annualised
- if a worker post SPA is paying NICs, they should be entitled to gain additional pension if they do not already have a full 35 year contribution record. Although this will not help many such workers (as they will already have contributed enough for a maximum state pension) there will be some older workers who are continuing to work because of a reduced pension entitlement who could benefit usefully
- if the individual worker does need additional support, that is best delivered through the benefits system rather than adding complexity to the tax system

8.34 Although the main impact will be on individuals, we note that there will be administrative savings for payroll administration. There would be one less Category to deal with, with no need to monitor the age of employees and obtain proof of age.¹³ HMRC would presumably also have some small compliance savings.

8.35 There would be no impact on employers' NICs.

8.36 At a time when people are increasingly continuing in employment, whether from choice or necessity after attaining the SPA, it is increasingly difficult to justify the age exception. This is particularly so when the basis of the exception (with the link to the earnings rules) and the nature of the contributory principle are considered properly.

8.37 There is of course no suggestion that NICs should be extended to pension income. That in any event is ruled out by the OTS's Terms of Reference.

Finally, are NICs a tax?

8.38 The notion that NICs are not a tax mystifies and annoys taxpayers. The argument is correct at a technical level on two grounds:

- 1 in the UK 'taxes' are paid into the Consolidated Fund and are legislated for in the annual Finance Bill. In contrast NICs are paid into the NIF and generally are provided for in social security legislation. There is a position therefore that, constitutionally, NICs are not a tax. (See more on the constitutional position of NICs at Chapter 13).
- 2 social security contributions (being contributions which are linked to the receipt of social security benefits) can be distinguished from taxes on income, profits and gains, taxes on goods and services, and other taxes

¹³ Though such records are necessary while Employers' NICs continues to include exemptions for those under aged 21 and apprentices under 25.

8.39 For the citizen the case can simply be put that a charge imposed by the government which is not in return for services, or is not a fine, is a tax.¹⁴ This accords with the general definition used by the OECD

“Taxes are compulsory, unrequited payments to general government. They are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments. The OECD methodology classifies a tax according to its base: income, profits and capital gains; payroll; property; goods and services; and other taxes. Compulsory social security contributions paid to general government are also treated as taxes, and are classified under a separate heading.”¹⁵

8.40 This approach is used by the Office for Budget Responsibility which categorises NICs under the general heading of ‘Income Taxes’.¹⁶

8.41 An individual’s (or a corporate employer’s) understanding of tax is not helped by maintaining that NICs are not a tax. NICs are a tax in all practical and common sense use of the word and the fiction that they are not should be avoided.

8.42 In this report we refer to NICs as a tax and payers of NICs as taxpayers.

¹⁴ Or royalties

¹⁵ data.oecd.org/tax/tax-revenue.htm

¹⁶ budgetresponsibility.org.uk/brief-guides-and-explainers/public-finances/

Discussion: changing the structure of employees' NICs

9 NICs

Annual, cumulative and aggregated assessment periods for employee's NICs on employment income

9.1 Using the definitions set out at paragraph 9.8, this chapter describes:

- the current method of determining IT on employment income, and NICs liabilities
- the case for changing this in relation to NICs, and various options for achieving this. We recommend that an annual, cumulative and aggregated approach would be a significant simplification, with the adoption of a new NICs code, similar to the current IT PAYE code
- the potential financial impacts for individuals, the exchequer and employers. This would be a fundamental change in the way NICs works for individuals and in the payroll processes required by employers. More work is needed to fully understand the impacts
- other related issues

Current differences between the ways IT and NICs are assessed

Income Tax

9.2 IT, like most of the rest of the tax system, is calculated on an annual basis, with a Personal Allowance and thresholds for basic and higher rates of tax applied to taxable income over the year in total. IT deducted through PAYE works on a cumulative basis - deductions in each earnings period usually take account of previous pay and tax paid in the year to date when the tax due for a current earnings period is worked out. The Personal Allowance and rate thresholds apply to total taxable income across all employments and other relevant income. Thus IT is applied across all employments in aggregate, regardless of how many separate employments the taxpayer has.

9.3 Liability to IT is only finalised after the end of the tax year. The final liability takes account of any changes in a taxpayer's circumstances during the year, including income from other sources such as savings and pensions. Effectively, what is collected by employers through PAYE during the year is only a provisional deduction, though for the vast majority of taxpayers PAYE gets to the right answer. When the tax year ends, a reconciliation process automatically takes place where income from all employments are brought together, allowances are deducted and the tax due calculated and compared with what has been deducted in the tax year. Any shortfall is then sought from the taxpayer (often via coding adjustments) and any overpayment is repaid by HMRC.

NICs

9.4 In contrast, NICs are assessed on earnings in each earnings period (normally weekly or monthly), with weekly or monthly thresholds applied to each period in isolation. Generally there

is no annual assessment, as occurs with the end of year reconciliation for tax (but see below for overpayments where an individual has multiple employments and see Chapter 10 for an annual element in the calculation of Employers' NICs; directors are also assessed on an annual basis) and there is rarely a need to consider previous or future weeks or months. NICs thresholds are applied to each employment in isolation – so, unlike IT, separate employments are not aggregated. Non-aggregation means that a person with two concurrent jobs benefits from weekly or monthly thresholds in each employment, potentially giving them the full amount of 'NICs-free pay' in both employments.

9.5 All liability to NICs is finalised within the earnings period at the end of each week or month. This approach is linked to the fact that NICs provide entitlement to contributory benefits and statutory payments, and the tests to determine that entitlement depend upon the amount paid each earnings period.

9.6 As a result of these differences in assessment, the process by which employers know what IT and NICs to deduct is also different. A tax code, provided by HMRC to employers, is the means by which employers know what IT to deduct through PAYE. By contrast, employers know what NICs to deduct by referring to a table of NICs category letters, selecting the appropriate letter for each employee. One of the key differences in dealing with changes of employment is that whereas employers are generally provided with a PAYE code for tax, they need to decide the NICs category letter themselves.

9.7 Although there is the potential to benefit from multiple primary thresholds if an individual has more than one job concurrently, there is a limit to the NICs payable at the full 12% rate. In effect each individual has only one upper earnings limit. Excess NICs paid can be repaid on making an application to HMRC, or prevented (again on application to HMRC) by seeking 'deferment' of NICs which would otherwise be due in an employment. Respondents in our meetings told us that both processes can be lengthy and difficult for ordinary taxpayers.

The case for reform

Definitions

9.8 To help the discussion below, there are a number of terms to outline

Assessment period: The period of time in respect of which the assessment of the amount of tax payable is calculated.

Earnings period: For employees' NICs under the current rules, the period of time in respect of which NICs are assessed, generally either weeks or months.

Annual basis: An annual threshold (sometimes termed an allowance) which results in a certain amount of earnings on which no NICs are paid. An annual basis requires a reconciliation to ensure that no more or less than the annual allowance is received. Unless there is also aggregation (see below) an annual basis would apply per job. It requires a scaling back mechanism related to the length of time a person is in a job, otherwise successive short term jobs would each attract an annual allowance. An annual basis affects those with fluctuating earnings and those working part year, as well as those who have earnings from employment and self-employment.

Cumulative: This refers to the way in which the tax is collected and has only a cash flow and administrative effect. On a cumulative basis an annual allowance of, say, £12,000 would mean that the NICs liability each month would be calculated on the assumption of an allowance of £1,000 per month for the tax year to date. So two months in, it would be £2,000 etc. A cumulative basis and a non-cumulative basis lead to the same NICs liability, though cumulative

operation gets to the right answer as it goes along whereas non-cumulative requires an adjustment (probably after the year-end). The mechanism could be a proportionate allocation of an annual allowance by the employer or a code.

Aggregated: This refers to the aggregation of an individual's employments (whether concurrent or consecutive). Making NICs aggregated would mean that the allowance would be per person – not per job. This would affect people with more than one job.

Discussion

9.9 No significant alignment of IT and NICs can take place while NICs continues to operate on an earnings period basis. The existence of a different earnings period basis for NICs means that any individual or employer who wants to understand the NICs system has to grasp a completely different set of concepts to those they may be familiar with for the tax system, which operates on an annual basis. This is a cause of complexity and contributes to the lack of understanding frequently cited as an issue with NICs. Moving to an annual basis for NICs was overwhelmingly supported by those who made written and oral representations to us.

9.10 Changing to both an annual and a cumulative basis would, in addition, help address the fact that correcting NICs errors is harder than correcting tax errors. The way annual and cumulative payments work for IT provides greater flexibility to correct any mistakes over the course of a year and in an end of year reconciliation. Employers and taxpayers suggested that correcting any errors in NICs deductions is more difficult and time consuming to perform under the earnings period system. Such mistakes can be more common where an employee has irregular payments, such as overtime, bonuses or reimbursements for expenses. HMRC's view is that such corrections should not be difficult to achieve within RTI.

9.11 An annual system of NICs would be less distortive and provide more equitable outcomes. Employees with similar earnings over the year may pay very different amounts of NICs (see example below). The fact that NICs are calculated per earnings period and per employment means that the amount an individual is liable to pay can vary significantly depending on their working pattern. In some cases this can also have an impact on their entitlement to benefits. It is inequitable and distortive but we have no evidence that this is a deliberate policy intention: it is essentially a legacy of general working patterns in the past.

Box 9.A: Examples of distortions with current NICs earnings periods

John is paid £130 a week but for thirteen weeks in the year he undertakes some overtime and his earnings rise to £230 in each of those weeks. In total John earns £8,060 for the year. He is only required to pay NICs in those weeks where his earnings reach the Primary Threshold of £155. John pays **£117** in NICs over the year: 13 weeks x (£230 – £155) x 12%.

Mike earns exactly the same amount as John: £8,060 for the year. However, his earnings are spread evenly across the year. He earns a consistent £155 a week. He therefore pays NICs every week on earning above the Primary Threshold of £155. He pays **no** NICs over the year: 52 weeks x (£155 - £155) x 12%.

Mike therefore pays less NICs across the year than John despite having the same overall earnings. This is because Mike's earnings are at the employee's NICs threshold in each earnings period and he is therefore entitled to the maximum weekly amount of NICs-free pay every week.

Box 9.B: Example for employees with multiple employments

Fiona has one full time job, which pays her £260 per week. In total Fiona earns £13,520 and is required to pay **£655.20** in NICs: 52 weeks x (£260 - £155) x 12%.

Carol has two part-time jobs. In each job she earns £130 per week. In total Carol also earns £13,520 over the year. However, because her weekly earnings in each employment are below the Primary Threshold of £155, Carol pays **no** NICs.

Despite paying different NICs, all the individuals in these examples would have a full National Insurance record for the year. This is because their weekly earnings are above the Lower Earnings Limit of £112 per week. See Chapter 8 for the interaction of NICs and benefits.

9.12 The impact of the current earnings period rules on a particular group of individuals has been reviewed by DWP.¹ This concerns the pension entitlement of people with multiple very low paid jobs ('mini jobs') which each pay below the Lower Earnings Limit (LEL) but where their combined earnings are above the LEL and who are not gaining a qualifying year for the State Pension. Estimates of the number impacted have been produced, indicating that:

- at any one time around 50,000 people have concurrent low paid jobs, which if earnings were combined would exceed the annual LEL. This number has remained broadly stable for the last 15 years
- a high proportion of those in this group are women and under age 25
- the population is not static so many of those affected may build up sufficient qualifying years in the future through paid or credited contributions²

Options for alignment

9.13 We have proceeded on the basis that any alignment of IT and NICs as regards assessment and payment periods will move NICs towards the IT model. We have raised the opposite possibility with some groups, received short shrift and have not pursued the concept further.

9.14 Currently, most employees pay Class 1 primary NICs at a rate of 12% on their earnings above a weekly threshold (the Primary Threshold) which is currently £155 per week. Above a higher threshold – the Upper Earnings Limit (currently £815 per week) – the rate reduces to two per cent. If the employee is paid every month, equivalent monthly thresholds apply. These are applied to a single earnings period in isolation.

9.15 Under an annual system, employees would have an annual Primary Threshold and Upper Earnings Limit applied to their total earnings received during the whole of the tax year. Effectively, the Primary Threshold would become a single annual NICs-free allowance similar to

¹ www.gov.uk/government/uploads/system/uploads/attachment_data/file/209863/ad-hoc-multiple-jobs.pdf
www.gov.uk/government/statistics/state-pension-coverage-lower-earnings-limit-and-multiple-jobs-july-2014
www.gov.uk/government/uploads/system/uploads/attachment_data/file/405850/LEL-and-mini-jobs-Feb-15.pdf

² A wider group could also potentially miss out on State Pension cover because of the earnings period rules, these are typically people: a) whose earnings fluctuate above and below the LEL but taken over the course of the year fall below the annual LEL; or b) with intermittent employment eg term-time workers whose earnings averaged over the course of the year are below the annual LEL; or c) low earners who change jobs midway through the year and have gaps in employment eg work for 4 months in one job and 7 months in the other, depending on their level of earnings.

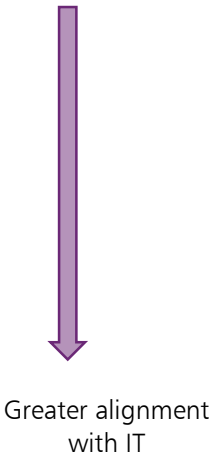
the Personal Allowance for IT. If the employee was employed for only part of the year the full annual allowance would still be available for the whole of that tax year.

9.16 We have considered alternative means of operating NICs on an annual basis, extending the NICs period of assessment from each individual week or month to the whole tax year, and doing away with the finality associated with weekly or monthly earnings periods. This chapter looks at options for changing the NICs that employees pay (Class 1 Primary) onto an annual basis. Chapter 10 sets out options for reform of employers’ NICs (Class 1 Secondary) including a change to an annual basis.

9.17 There are various options for operating NICs on an annual basis, with differing degrees of alignment with the manner in which IT operates. These are summarised in the table below and then discussed in more detail, concluding with the recommendation that an annual, cumulative and aggregated approach is adopted, with a dedicated NICs code (Option C).

Table 9.A: Summary of the options for operating NICs on an annual basis

| | Nature of annual basis | Outline description |
|---|---|--|
| A | Annual | For a single employment income source, total annual income determines NICs liability |
| B | Annual and cumulative | As above, and collection process takes account of previous pay and NICs deductions in the year. Collection process could use a pro-rated threshold(see below) |
| C | Annual, cumulative and aggregated, with dedicated NICs code alongside IT code | For all sources of employment income, total annual income aggregated to determine NICs liability and collection process takes accounts of previous pay and NICs deductions in the year Dedicated NICs code allows collection of NICs liabilities through the year; requires each taxpayer to have 2 codes. ³ |



9.18 This chapter sets out each option in turn. Each section explains how the calculation of Class 1 primary NICs would differ. We also include a table summarising the assessment of options B and C.

9.19 It is necessary to consider the interplays between the recommendation on this issue and those for other issues in our report, in particular:

- the opportunity to align the tax and NICs treatment of earnings (Chapter 11); and
- to consider reforming Employers’ NICs (Chapter 10)

All the options will have impacts on the amount of NICs employees pay and the way that NICs determine access to contributory benefits.

Option A: annual Class 1 primary NICs, not cumulated and without aggregation

9.20 The existing weekly or monthly thresholds become annual thresholds, and the finality associated with shorter earnings periods is removed. For example, the weekly Primary Threshold of £155 per week would become an annual threshold of £8,060.

³ A combined IT and NICs code is possible but we do not consider it a feasible option currently (see paragraph 9.37).

9.21 Thresholds would need to be applied in equal weekly or monthly amounts because an employee would only be entitled to the proportion of the Primary Threshold relating to the pay period. Without cumulation (see below) fluctuating pay within an employment (for example agency nurses, fruit pickers, unpaid leave) would lead to under or overpayments of NICs and an annual reconciliation would be required in all such cases. This would introduce complexity which can readily be avoided by adopting a cumulative approach.

Option B: annual Class 1 primary NICs, cumulated within an employment but without aggregation

9.22 An annual and cumulative system of Class 1 primary NICs, but not aggregating across employments, is a more significant step towards alignment. The existing weekly or monthly thresholds become annual thresholds, and the finality associated with earnings periods is removed. For example, the weekly Primary Threshold of £155 per week would become an annual threshold of £8,060.

Calculation

9.23 The charge would be assessed cumulatively in an employment:

- for a whole tax year, or
- for the length of the employment if less than a year, with thresholds adjusted pro-rata

9.24 Employees with two or more jobs (concurrently or consecutively) would have two or more separate assessments of liability based on their earnings in each job. When an employee leaves their job the period of assessment would end. Employers would therefore not be required to reflect information about NICs paid in other employments as they do for Income Tax. There would not be a need for a NICs code. NICs category letters would continue to be the method for informing employers of the rates of NICs to apply.

9.25 Thresholds would need to be applied pro-rata because an employee would only be entitled to the proportion of the Primary Threshold relating to the length of that particular employment. If they were in the same employment for the whole tax year then they would receive the full Primary Threshold. However, if the employee commenced that employment half way through the tax year then they would only be entitled to a maximum of six months' worth of the Primary Threshold. Pro-rating would be necessary because otherwise an employee could benefit from more than one year's worth of the Primary Threshold in multiple consecutive employments and thus underpay employee NICs. An annual reconciliation would be necessary. An example is set out in Box 9.C.

9.26 The rules would need to be able to deal with situations where an employee receives earnings before the employment formally starts or after it has ended. A robust definition would be required to define and police when the employment starts and ends. Without this, employers could seek to manipulate when an employment started and finished to increase artificially the duration of employment. This would enable the employee to benefit from a higher pro-rata annual Primary Threshold. The same aggregation rules as exist now would be needed to prevent contract splitting.

Box 9.C: Pro-rating of annual NICs thresholds – an example

An employee commences employment at the start of month 7 and stays in that employment until the end of the tax year. They would benefit from 6 months (months 7 – 12) of the annual Primary Threshold. In 2015-16 this would equate to a 'NICs-free' amount of

$$6/12 \times \text{£}8,060 = \text{£}4,030$$

Pro-rating is necessary to ensure employees do not benefit from the annual threshold more than appropriate. If for example the employee had one job for the first 6 months and changed immediately to start a new job for the remaining 6 months of the year, and if no pro-rating of thresholds were used, the employee would benefit from 12/12ths of the Primary Threshold in their first job and 12/12ths (because of cumulation) in the second, in the same year, a total 'NICs-free' amount of £16,120 (£8,060 + £8,060).

9.27 This could be an end point in its own right or a stage in reaching an annual, cumulative and aggregated approach. We do not recommend Option B as it does not address the distortion caused by multiple concurrent employments, see Options C. If Option C is adopted, we consider it would simply confuse the change to introduce Option B as a staging post. Accordingly we think that reform should go straight to Option C.

Option C introduction: annual, cumulated and aggregated Class 1 primary NICs

9.28 Class 1 primary NICs could operate on an annual, cumulated and aggregated basis of assessment in essentially the same way as IT

9.29 Through the PAYE system, Class 1 primary NICs deductions would follow the same cumulative process that applies for IT, taking into account previous pay and the primary NICs paid to date, including any previous primary NICs deductions made by a previous employer in that tax year.

9.30 This means that:

- all earnings across all employments in the year, however small, will be taken into account in calculating the employee's annual liability to Class 1 primary NICs; and
- earnings from previous earnings periods in the same tax year in the same employment will be taken into account in calculating the employee's primary NICs payable on the new cumulative basis

9.31 To completely align with IT, the annual Class 1 primary NICs thresholds would apply to all earnings in the year, aggregated across all employments. Consequently, to be correct, the amount of NICs collected through PAYE in one employment would need to take account of earnings from other employments too. This implies a NICs code similar to the current PAYE code.

Assessment of different approaches to an annual basis for NICs liabilities

9.32 Table 9.B provides an assessment of whether a move to an annual and cumulative (Option B) or an annual, cumulative and aggregated (Option C) system of Class 1 primary NICs constitutes a simplification and compares the two. The implications of the change are presented against five objectives. With both options, some individuals might see a change in the level of NICs they pay and the entitlements they receive (see paragraph 9.47).

Table 9.B: Annual and cumulative or annual, cumulative and aggregated Class 1 primary NICs – assessment against simplification objectives

| Objective | Option B Effects of annual, cumulative but not aggregated Class 1 primary NICs | Option C Effects of annual, cumulative and aggregated Class 1 primary NICs |
|--|--|--|
| Reduce compliance burdens for taxpayers and employers | <p>This option would see the calculation and operation of NICs move onto an annual, but still quite different, basis to IT. A new concept of pro-rating annual allowances would be introduced into the tax system.</p> <p>It would be easier for employers to correct NICs errors retrospectively.</p> <p>This option does not create the same opportunities as option C for closer alignment in the treatment of earnings.</p> <p>No NICs code would be necessary, but it would still be necessary for employers to use NICs category letters to identify the appropriate NICs rate for each employee.</p> <p>Additional complexity may arise from the need for rules to deal with employees joining or leaving part way through the year, or who work irregularly, as well as for payments made before or after the start of employments.</p> <p>Employers will still need to aggregate earnings where there are multiple employments with the same or connected employers.</p> <p>Employers' NICs could remain unaltered.</p> | <p>The calculation and operation of NICs will move onto the same basis as IT. This may make it less costly for employers to work out NICs liabilities. However, for the majority of employers who use payroll software there may only be a limited reduction in costs.</p> <p>It would be easier to retrospectively correct NICs errors. It would no longer be necessary for employers to operate a separate process for Directors' NICs.</p> <p>This option would facilitate considerable alignment in the treatment of earnings for IT and NICs.</p> <p>Employers would no longer need to identify the appropriate NICs category letter for an employee. Instead the NICs code would contain the appropriate letter. However, the introduction of a NICs code could add additional complexity. Employers may receive more queries from employees if a NICs code appears alongside tax codes on payslips. The presence of a tax code, particularly a changing code, alerts employees that they may now be paying more tax. This gives tax greater transparency. Introducing a NICs code (that may also change in-year) may raise the profile of NICs and lead to an increase in employee contact with the employer and HMRC.</p> <p>Employers' NICs would either remain as at present, and so would no longer largely mirror Employees' NICs in its structure, or it could be reformed onto a new basis (Chapter 10).</p> |
| Remove distortions | <p>With the introduction of annual thresholds, the amount of NICs paid by an individual would no longer be affected by their pattern of earnings over the year. For instance, there would no longer be an incentive for an employee to request to their employer that bonus payments are paid in one earnings period rather than over several in order to benefit more from the lower additional rate.</p> | <p>As for Option B</p> <p>An annual system of employee NICs presents opportunities to move employer NICs to an annual basis too. Options to do so are discussed in Chapter 10. Taken together, what could emerge is an entire NICs system on an annual basis, running alongside the Income Tax system. Depending upon the options chosen, this</p> |

| Objective | Option B Effects of annual, cumulative but not aggregated Class 1 primary NICs | Option C Effects of annual, cumulative and aggregated Class 1 primary NICs |
|--|---|--|
| | <p>However, the change may introduce new distortions by creating a new incentive for employers to manipulate the duration of employment in order to enable employees to benefit from a larger pro rata primary threshold.</p> | <p>could be less distortive in a number of ways.</p> |
| <p>Improve transparency</p> | <p>It is likely that the operation of NICs would be simpler for individuals and employers to comprehend if it followed the same annual operation as tax.</p> <p>However, the two systems would still differ in important ways.</p> <p>Employers would still have to start from a different basis for each (a tax code and a NICs table letter).</p> | <p>The operation of NICs would be simpler for individuals and employers to comprehend if it followed the same annual and aggregated operation as tax.</p> <p>The two systems would be as close as possible short of merger.</p> <p>This change also raises the possibility of reforming the way the entitlement tests for contributory benefits work, and making them more understandable (see paragraph 9.61).</p> |
| <p>Deliver fairer outcomes</p> | <p>The change will deliver fairer outcomes in some circumstances. For example, all employees will be treated equally by the NICs system, regardless of when they are paid during an employment. However, it would not change the current unequal outcomes where employees have multiple jobs.</p> | <p>The NICs system would be fairer in that the amount of NICs paid by an employee would no longer be affected by their pattern of earnings over the year or the number of jobs they have.</p> |
| <p>Reduce administrative costs for HMRC</p> | <p>Some employees may be encouraged by the changes to have greater involvement in their own NICs affairs. This may mean HMRC have to deal with more queries.</p> <p>There will also be the potential for more end of year adjustments, when the amount of NICs deducted during the year does not match the final annual liability.</p> <p>HMRC's administrative costs may therefore increase.</p> | <p>HMRC may initially face increased costs in its administration of PAYE for the following reasons:</p> <ul style="list-style-type: none"> • HMRC will issue NICs codes alongside tax codes, which may need more explanation and result in more queries from individuals • Some employees may have greater involvement in their own NICs affairs which may mean HMRC have to deal with more queries • There will be the potential for more year-end adjustments. However, in many cases the underlying cause of a year-end adjustment will be the same for NICs as it is for tax. |

9.33 We consider that option C would bring Employees' NICs very close to IT, making the tax easier to understand and with more equitable outcomes for individuals. We therefore recommend it as the better means of simplifying the tax. However, there are many challenges with this approach (see paragraph 9.47) and so our recommendation in principle must be

accompanied the acknowledgement that further work must be done to understand the practical impacts.

Operating Option C: a NICs code

9.34 Our conclusion is that Option C is the route to go, so we now turn to how it would operate in practice.

9.35 If Class 1 primary NICs are to be aggregated across employments, a system that tells employers the position in an employee's other activities will be needed. That implies a NICs code - HMRC would provide a NICs code to an employer in order for them to know whether their employee is entitled to the annual Primary Threshold (NICs-free pay) for that employment, and what rate of NICs to apply.⁴ For example, where the individual is already using up all of their 'NICs-free pay' from the annual Primary Threshold in one job, Class 1 primary NICs will need to be deducted from every pound of their earnings in any second and concurrent job. Codes can provide this kind of information, as well as allowing for any underpayments from a previous year to be factored into them.

9.36 The introduction of coding for NICs would be a fundamental change to the operation of PAYE/NICs. There are two ways that it could be achieved:

- 1 a combined tax and NICs code that would include all the information an employer would need to deduct the correct amount of tax and NICs, or
- 2 a dedicated NICs code, to run in parallel to the tax code

A combined PAYE and NICs code

9.37 A combined code has to be preferable in principle (one must be better than two) but it has considerable operational difficulties. The design and maintenance of the code would be more complex:

- the PAYE code has to take account of other income, much of which would not be subject to NICs
- the definition of earnings for IT and NICs differ (though we recommend elsewhere that they be harmonised)
- the IT and NICs thresholds are different (though this could be managed arithmetically)

9.38 It is worth noting that with the changes to the taxation of savings income and dividend income, tax codes are potentially becoming simpler for many people. Developing this trend further may make it easier to combine codes. Looking further into the future, there have been suggestions that tax codes could be eliminated as real time reporting develops and the direct population of tax returns takes off. These routes may allow a single code for both IT and NICs, with IT on 'other income' collected directly (including by deduction at source) or through separate adjustments to pay facilitated by RTI.

9.39 This is too far into the future and we have not pursued the option of a single code further. However, we recommend that the concept is kept under review as HMRC's systems are modernised and move towards the abolition of the tax return. Indeed, the ideal result is that tax

⁴ For an employee with more than one employer, each employer would receive a separate code, as with the present IT PAYE codes.

codes are rendered obsolete by automation – something that RTI and HMRC’s Personal Tax Account may enable.

A separate, dedicated NICs code

9.40 We consider it is necessary at this stage to introduce a dedicated NICs code running in parallel to the Income Tax code to enable our preferred Option C to be effected. Income Tax codes would continue to operate as they do currently. Although there would be two codes and two calculations, these would be based on the same annual and aggregated methodology, enabling employers to run the same process for NICs as they do for Income Tax.

9.41 A desirable model for a NICs code would be a code that replicates the function of the tax code but adopts a different format.⁵ This would have the advantage of having a familiar concept to the tax code, making it easy to understand for those who are already familiar with tax codes. However, it would also look sufficiently different to limit the risk of the two being confused, such as a NICs code being used to calculate an employee’s Income Tax or vice versa.

9.42 To achieve a sufficiently different look, the NICs code would have a different alphanumeric format. For example, a standard suffix NICs code might show all the digits in the code, rather than be truncated by one digit like the tax code. It might also have different suffix letters. So a person with a Primary Threshold of £8,060 might have a NICs code of 8060A. The number is the amount of NICs free pay and the letter represents information about the rate at which NICs are to be charged. In this example ‘A’ represents the standard rate of NICs. (This is similar to the table letters currently used by employers to determine the correct NICs rate for each employee).

9.43 The mechanism for providing information about the NICs code could replicate the IT PAYE code process using an extended P45. For an employee with more than one employer, each employer would receive a separate code, as with the present IT PAYE codes.

9.44 We accept that two codes could mean twice the confusion, given that so many employees do not understand their PAYE code. That position is probably improving with better information but our proposal for a separate NICs code emphasises the need for clear information and explanations, including the consolidated coding notice we have previously recommended to avoid the shower of coding notices too many taxpayers currently receive.⁶

9.45 While we consider that moving to an annual and aggregated basis would be a major simplification of NICs, the financial impacts for individuals and employers are potentially significant. This is explored in the next section.

9.46 As well as the financial costs and savings there are the gains to taxpayers in transparency and fairness from this reform. It is impossible to ascribe a monetary value to these but some have argued that these alone mean that change is worthwhile.

Annual, cumulative and aggregated assessment periods for employee’s NICs – indicative impact on individuals and the exchequer on employment income

9.47 There are number of employment features which could give rise to different outcomes for individuals if NICs moves to an annual, cumulative and aggregated (ACA) basis. The three key

⁵ There are various approaches to the design of a dedicated NICs code: a) a NICs code that replicates the function and format of the tax code; b) a NICs code that replicates the function of the tax code but adopts a different format; and c) a NICs code that adopts a different approach to the tax code and functions by apportioning the NICs thresholds.

⁶ See the OTS Pensioners report Taxation of Pensioners Review <https://www.gov.uk/government/publications/taxation-of-pensioners-review>

features are described below, together with the main reasons why these may lead to different NICs outcomes

Table 9.C: Impact of different working patterns

| | |
|---------------------------|--|
| Part year workers | <p>Workers who do not work for a full year.</p> <p>At present they benefit from a weekly / monthly primary threshold in each period they work. With an ACA basis they would benefit from the annual threshold despite working only part of the year (so the same basis as for IT).</p> <p>Part year workers should therefore benefit from an ACA basis and pay less NICs. The exception would be part year workers whose pay in some earnings periods exceeds the upper earnings limit and is taxed at 2%. These workers, while benefitting from an annual allowance, would cease to benefit from multiple upper earnings limits, so more of their income would be drawn into the 12% bracket.</p> |
| Fluctuating income | <p>Workers whose income fluctuates during the year. Within this category are workers who, for example:</p> <ul style="list-style-type: none"> • Are paid on a commission basis • Receive a bonus • Receive a pay rise on promotion • Change of jobs with different levels of pay • Change of number of hours worked (eg full time to part time and part time to full time) <p>The potential impact of an annual approach on these workers is similar to that for part year workers.</p> <p>Those with fluctuating income who would pay more NICs include:</p> <ul style="list-style-type: none"> • Someone who goes from pay period earnings below the UEL to above the UEL for part of the year, but still has annual earnings below the UEL. They currently benefit from paying NICs at 2% for earning above the UEL in a pay period, whereas under the annual system this would be charged at 12% on more of their earnings • Someone who goes from pay period earnings below the Primary Threshold to above the Primary Threshold for part of the year, and has annual earnings above the Primary Threshold. They currently benefit from not paying NICs in some pay periods, but under an annual system they would be charged at 12% (or 2%) on more of their earnings <p>Those with fluctuating income who would pay less NICs include someone who goes from pay period earnings above the Primary Threshold to below the Primary Threshold for part of the year, and has annual earnings below the Primary Threshold. They currently pay NICs in some pay periods, but under an annual system they would no longer be charged 12% on their earnings.</p> |
| Multi jobbers | <p>Workers who hold more than one job in a single tax year. This can be either:</p> <ul style="list-style-type: none"> • individuals who change job and therefore have consecutive employments or • individuals who have more than one employment at any point in the year and therefore have concurrent employments <p>At present these individuals benefit from a weekly / monthly primary threshold in each pay period of each job they work. This can generate a NICs advantage against someone earning the same amount over a single employment.</p> <p>If all jobs are aggregated they would benefit from only one primary threshold and so more of their income would be subject to NICs if they currently work for more than a years' worth of pay periods and therefore receive more than a years' worth of PT allowance.</p> |

9.48 HMRC have provided us with data on the impacts of moving to an annual and aggregated basis for calculating employee's NICs. This data is indicative only, it has a number of limitations and should not be regarded as describing definite outcomes.

Box 9.D: Data Source

2012-13 Survey of Personal Income (SPI). 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 2018-19 based on the 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 2012-13 and earlier years.⁷

Information in the charts below is derived from this model.

Data limitations relating to annual and aggregated NICs

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 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.

The modelled output cannot be broken down by gender, age, economic sector or geographic area because of constraints of the size of the samples.

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.

9.49 Changing to an ACA basis for NICs would lead to many individuals paying less NICs and many paying more (see below). It is challenging to describe these in any terms other than 'cash gainers' and 'cash losers', but when doing so the following should be borne in mind:

- gainers and losers emerge across all income ranges
- gainers generally have lower incomes than losers

⁷ Methodology and quality indicators for the sampling and projection process which underpins this analysis can be found within the following publication:
www.gov.uk/government/uploads/system/uploads/attachment_data/file/428961/Income_Tax_Liabilities_Statistics_May_2015.pdf

- the proportionate impact on a higher income loser is less than on a lower income loser
- losers at present benefit from the particular structure of NICs and the ensuing demonstrably unfair outcomes. We do not know of any policy rationale for these outcomes

Illustrative impacts of an annual and aggregated basis for calculating employees' NICs

Overall outcome

9.50 The indicative information suggests that the consequence of moving to an annual, cumulative and aggregated basis could be as follows:

- A yielding outcome for the exchequer masks potentially positive and negative impacts for some significant groups of employees:
 - 7.1 million workers would pay an average of £175pa less NICs (£1.2 billion in total)
 - 6.3 million workers would pay more on average of £275pa more NICs (£1.7 billion in total)
- In general, those who would pay less NICs in the future have lower incomes than those who would pay more

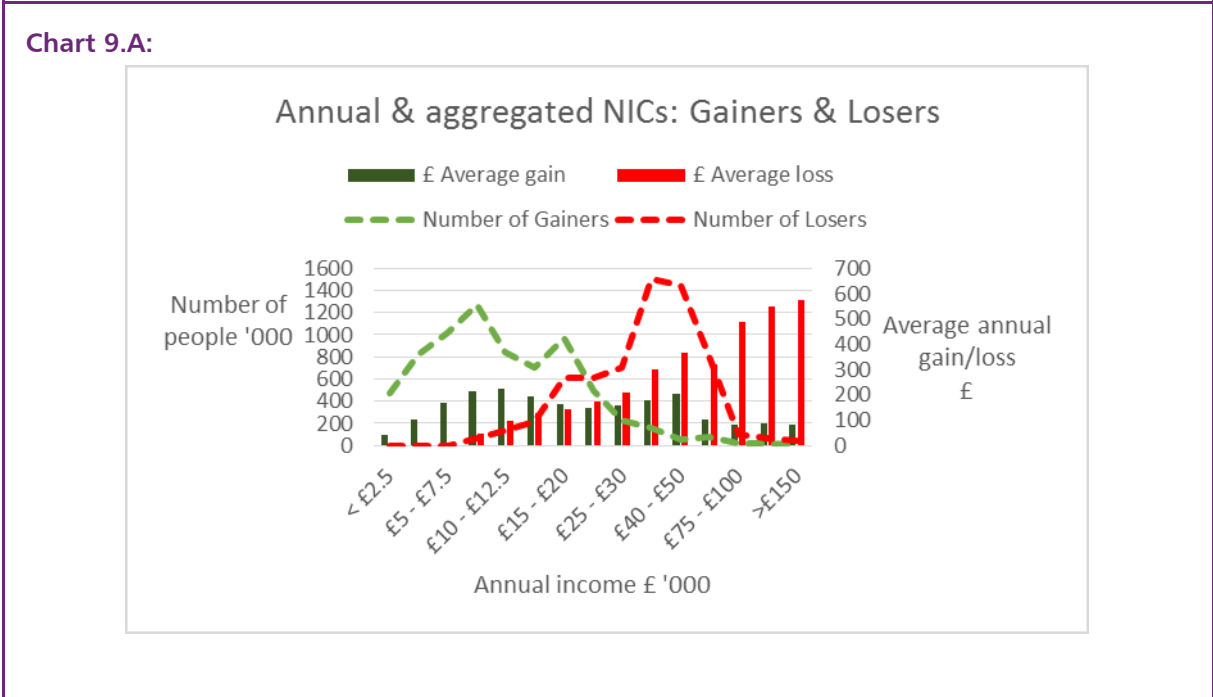
9.51 Charts 9.A, 9.B and 9.C illustrate the overall gainers and losers and then the main underlying feature of employment which gives rise to the gain or loss, in the three categories set out above (part year workers, fluctuating income, multijobbers). While an individual could be impacted by all these elements (eg someone could be a part-time, multijobber with fluctuating income) the analysis identifies only the largest cause of the change in NICs paid.

9.52 This information is based on the data source outlined in Box 9.D. Note that the income bands are not uniform

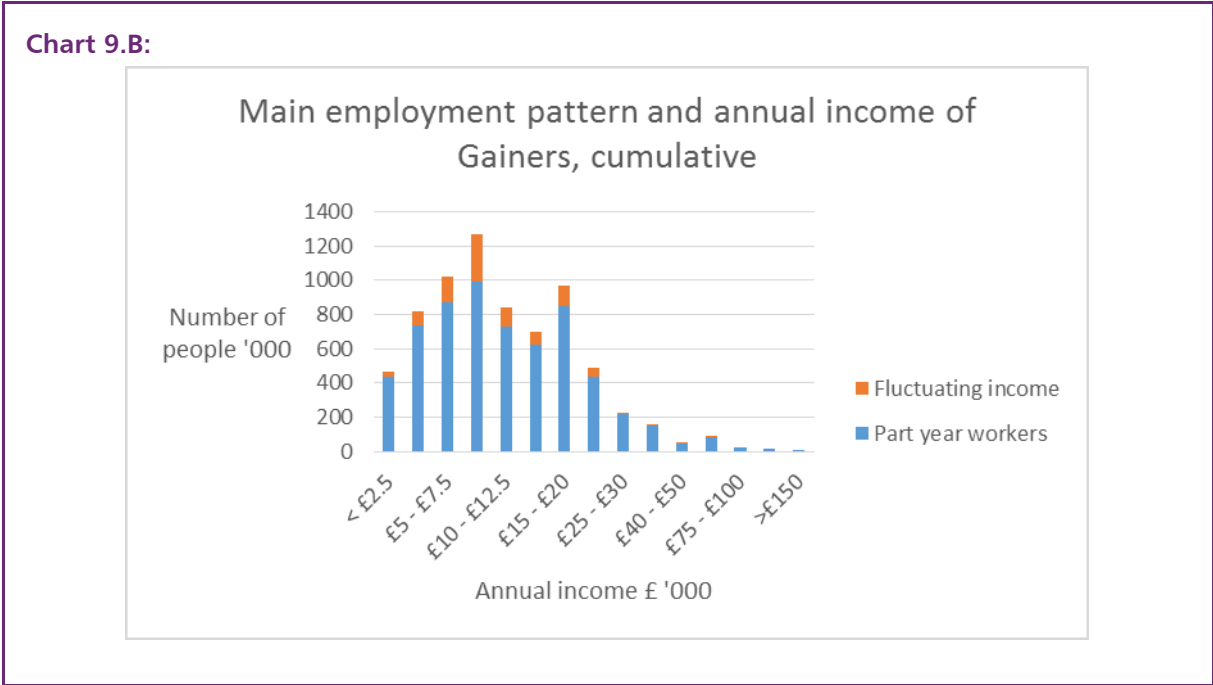
Table 9.D: Charts 9.A, 9.B and 9.C use the following terms

| | |
|---------------------------------|--|
| Annual income | Gross earnings before applying the primary threshold |
| Average gain/loss | Average cash gain or loss for individuals in each band of annual income if NICs move to an annual, cumulative and aggregated basis. There may be large ranges within the averages. |
| Number of gainers/losers | The number of people in each band of annual income who will 'gain', ie pay less NICs, or 'lose', ie pay more NICs, if NICs move to an annual, cumulative and aggregated basis. |

9.53 Indicative overall gainers and losers from moving to an annual and aggregated basis – this chart shows the number of people impacted at different income levels and the average annual gain or loss at those income levels.

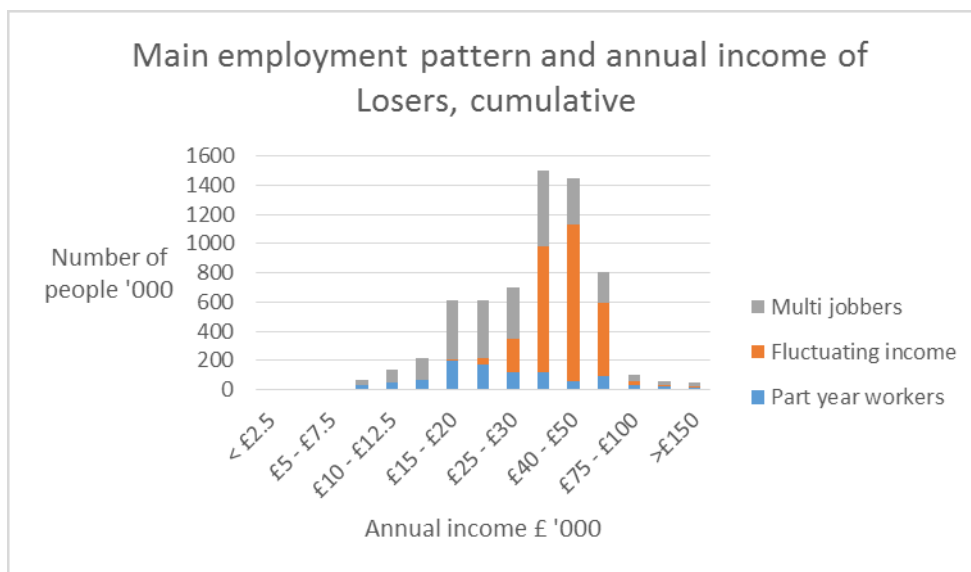


9.54 Employment features leading to individuals paying less NICs if an annual and aggregated basis is adopted – these are shown cumulatively.



9.55 Employment features leading to individuals paying more NICs if an annual and aggregated basis is adopted – these are shown cumulatively.

Chart 9.C:



Individual outcomes

9.56 Inferences on the impacts of ACA basis which may and may not be drawn from this information include:

'Cash gainers'

Amongst the low earners (earning less than £12,500) the analysis appears to show there are significantly more gainers (4.4 million) than losers (0.2 million) as part year workers would no longer make sporadic NICs payments. This may be a misreading, as an element of 'part year workers' may be individuals who do not work a full year because they are entering or leaving the labour market - they are not lifetime part year workers.

Entitlement impacts have not been modelled and the figures above cannot readily be translated into potential impacts on benefits. For example, at first sight the chart shows that a large number (about 1.6 million) of the cash gainers are in pay brackets where they would not (on an annual and aggregated basis) reach the LEL, so they would no longer accrue rights directly by paying NICs. However, these individuals may well be in receipt of benefits which accrue NICs credits with a similar status to NICs cash contributions. It is also possible that they are not accruing NICs paid entitlements currently because, although they are paying NICs, they are not achieving the required payment records (eg 26 weeks see Table 8.C).

'Cash losers'

The cash losers appear to be above the LEL level (at present £5,824 pa), so they should not lose benefit entitlements. However, about 200,000 of the cash losers are on low incomes (below £12,500pa) and may lose up to £100pa.

Conclusion on financial impacts for individuals and the exchequer

9.57 This brief exploration of the financial impact is based on the extrapolation of individual examples contained in the personal tax model (with the limitations set out above). While it is clear to us that an annual and aggregated basis would be a very significant tax simplification, it is also certainly the case that a much more detailed analysis is needed before this can be adopted as a policy.

9.58 RTI now provides a comprehensive dataset of taxpayer employment characteristics. Interrogation of this, and modelling, may arrive at a better understanding of the consequences of an annual, cumulative and aggregated basis. **We recommend that the potential for this is explored.**

Financial impacts for employers

9.59 Costs for employers will fall into two categories:

- 1 Transition costs are likely to be significant.
- 2 Subsequent administrative savings from operating two very similar systems, instead of two completely different ones, are difficult to gauge. We are not aware of any recent detailed study of the administrative costs of running payrolls

We have probed the issue of the savings (or additional costs) that will result from our preferred route in many meetings with businesses. The general view has been that administration savings will be modest at best, simply because almost all payrolls are run using software these days. (If a payroll is outsourced, it will be to an agent who uses software.) Thus the actual administration savings will be small and the additional costs of enhancing or amending payroll software must not be forgotten. At the same time, a good number of employers believe that the better understanding of NICs among employees will be helpful, not least in reducing the number of questions they have to deal with about issues such as NICs' earnings period basis. These aspects should be explored further with employers and software houses.

Further issues related to ACA

9.60 Any move towards assessing NICs on an ACA basis raises a number of related issues.

Entitlement tests for benefits

9.61 While the entitlement test for the state pension already operates on an annual basis (in that it requires a NICs payment record for complete tax years) entitlement to other contributory benefits is based on building up contributions for a specified number of weeks see Table 8.C. Moving to an ACA basis for the assessment of employee NICs would require consequential changes to the technical operation of the benefits tests. The recent consultation on the merger of Class 2 and Class 4 for the self-employed, and the consequent impact on the benefits entitlements of the self-employed, indicates the kind of innovative thinking which will be needed.⁸ Use of the information now provided through RTI should also be explored as a potential solution to linking ACA based NICs payments with entitlements.

Over and underpayments of NICs

9.62 An annual and aggregated system of NICs will in some cases give rise to a primary NICs over- or underpayment. This is because NICs deductions made in the year would become, like

⁸ 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

tax, provisional payments subject to a year-end reconciliation process. Deductions may not ultimately match the total NICs due figure when the year as a whole is reconciled, for example, where an employee has a number of changes in circumstances during the year.

9.63 Overpayments would be repaid by HMRC in the same way as those for tax. If the year-end reconciliation finds that NICs have been overpaid, it will either be repaid directly or off-set against any other underpayment.

9.64 Underpayments of NICs could be collected by either adjusting the NICs code or the IT code. Using the NICs code to collect NICs underpayments would seem the common sense approach. However, it would mean NICs codes would change more frequently, and potentially be harder to understand. An alternative would be to collect underpayments through the tax code. This would mean fewer adjustments to the NICs code, keeping the new code as simple as possible. NICs underpayments would only add one more adjustment to the many that can potentially already be put through the tax code. However, this latter approach blurs the difference between tax and NICs codes. It is something that would need to be considered in the design of the NICs code.

9.65 One point to emphasise is that in pointing to the need for NICs reconciliations under our proposed new systems, we are not imposing an entirely new burden on HMRC. Such reconciliations take place already, though not in such numbers as would probably be the case in the future. But the considerable increase in numbers of NICs reconciliations and possible adjustments would be much easier to effect under the ACA basis and would be done in parallel with PAYE reconciliations.

Legal liability

9.66 The legal basis of deducting NICs will change with employees taking greater responsibility, and the employer less. The current legal position is that the employer is responsible for paying all Class 1 NICs, but is permitted to recoup Class 1 primary NICs from the employee. With an annual basis there would no longer be finality in the earnings period, and there may be times when an employee leaves an employment with a NICs liability still to pay. Therefore the NICs position will have to move to that of IT - the employee will be legally responsible for paying NICs but the employer would be required to deduct NICs on their behalf.

Directors' NICs

9.67 Class 1 primary NICs for company directors are already assessed on an annual (but not aggregated) basis. The existence of a different process for directors necessitates additional work for payroll operators. With the proposed option, although a separate collection mechanism would no longer be necessary, particular issues around the timing of directors' receipts (which in the main relate directors' loan accounts) would remain. A move to aggregation would impact directors in the same way as other employed earners.

9.68 Overall we think that the ACA basis would be a simplification for directors' NICs.

Employment status

9.69 Whether a person is subject to IT and NICs as an employee or self-employed is generally determined by the terms and conditions under which they work. However, certain groups are treated as employed earners for NICs even where they are self-employed for tax purposes, and vice versa. This is another area of misalignment and complexity in the system. Employers have suggested that these regulations can be difficult to interpret and apply, and that they also add to the administrative burden by obliging employers to operate PAYE on individuals for NICs or tax purposes only.

9.70 A move to an annual basis for NICs would highlight this misalignment and question whether it should be maintained. We consider the whole area of employed vs. self-employed in Chapter 12.

9.71 The proposed structure implies that all individual earners, whether employed or self-employed, will have an annual NICs allowance. This will provide harmonisation for those who have several sources of income, including self-employment.

Employer population

10.1 The employer population is huge and diverse across a range of factors, including the economic sectors and industries in which they operate, the size of the workforce and the total paybill for each employer. As illustrated in the chart below, the vast majority of employers have 10 or fewer 'employments' and a small number of employers have very significant payrolls ('pay' in Chart 10.A is the aggregate level of payrolls for the relevant employer size).^{1 2} The administrative burdens borne by employers relating to the administration of PAYE and NICs are not in direct proportion to size, however measured.



The current NICs charge for employers

10.2 Employers are required to pay NICs (Class 1 secondary) on the same earnings on which employee NICs (Class 1 primary) are charged. Like employee NICs, liability is determined each earnings period and for each separate employment. Unlike Class 1 primary NICs, Class 1 secondary NICs are payable on earnings paid to employees over State Pension age.

¹ Employments relate to any period of employment of an individual by an employer.

² This chart is based on information provided to the OTS by HMRC in respect of a sample of employers from 2012-13, the latest year for which details are available. 'Pay' is pay subject to Employers' NICs before applying the Secondary Threshold.

10.3 Class 1 secondary NICs are charged at 13.8%, above a certain earnings threshold (known as the 'Secondary Threshold', currently £156 per week). There is no upper earnings threshold for secondary NICs.³

10.4 Employers also pay NICs (Class 1A) at a rate of 13.8% on those benefits in kind that they provide to their employees and which do not otherwise attract Class 1 secondary NICs (see Chapters 4 and 11). These contributions are calculated on an annual basis – ie the total taxable benefits paid to an employee over the course of the year – and are paid by employers as part of the end of year P11D process.⁴

10.5 Employers may also pay NICs (Class 1B) on items included in PAYE Settlement Agreements (PSA). PSAs are voluntary agreements between HMRC and employers to settle IT and NICs due on certain (typically minor or irregular) benefits in kind and expenses in a single payment. The employer pays Class 1B NICs on the value of the benefits and expenses and on the IT paid under the PSA. Class 1B NICs are therefore equivalent to the employer NICs that would have been due if no PSA was in place.

10.6 An Employment Allowance of £2,000 was introduced from April 2014 (increasing to £3,000 from April 2016). This is deducted from the employers' NICs liability of most employers.⁵ At its introduction 450,000 employers were expected not to pay employers' NICs and the increase in 2016 is forecast to take a further 90,000 employers out of paying employers' NICs.⁶

10.7 In the rest of this chapter we will refer to Class 1 secondary, Class 1A and Class 1B NICs collectively as 'employers' NICs' and to the specific classes when required. We will refer to Class 1 primary NICs as 'employees' NICs'. There is no equivalent to employers' NICs for the self-employed. This is the key factor in the differing tax paid in relation to employment compared with the self-employment.⁷

10.8 Employers' NICs are the largest single source of revenue into the National Insurance Fund (NIF, see Chapter 8), and have always been an integral part of the NICs regime. The rationale for this was given in the Beveridge Report, summarised in a House of Commons briefing paper as follows:⁸

'Beveridge made three arguments for levying contributions on employers as well as on employees and taxpayers

- An employer's contribution should be "regarded as a proper part of the cost of production, maintaining the labour force that is necessary both when it is actually working and when it is standing by."

³ Until 6 April 2016, where individuals are contracted out of the second State Pension, employers are entitled to an employer NICs rebate of 3.4 per cent on an employee's earnings between two thresholds (the Lower Earnings Limit and the Upper Accrual Point). Simplification to the current rules will be achieved from 6 April 2016 onwards when the introduction of a single tier pension triggers the removal of the contracted-out rebate and the Upper Accrual Point.

⁴ The P11D is a statutory form required by HMRC from UK based employers detailing the cash equivalents of benefits and expenses that they have provided during the tax year to their directors, and employees earning at the rate of more than £8,500 per year.

⁵ Certain employers do not qualify for the allowance: a) those who employ workers for personal, household or domestic work - unless they are a care or support worker, b) public bodies or businesses doing more than half your work in the public sector (except charities), and c) service companies with only deemed payments of employment income under 'IR35 rules'.

⁶ www.gov.uk/government/publications/employment-allowance-increase-to-3000/employment-allowance-increase-to-3000

⁷ See, for example, OTS Employment Status Report, March 2015

⁸ 'National Insurance Contributions: an introduction', Antony Seely, House of Commons Library Briefing Paper, September 2015

- It was in the employer’s interest that their employees should have security – against the risk of unemployment or sickness – and that they should “feel concerned for those who work under their control.”
- It was necessary to “give to employers a definite status, based on contribution, for making representations as to the administration of social insurance and its possible improvement”.’

10.9 Total employer NICs receipts in 2015-16 are estimated to be £64.8 billion (57% of total NICs receipts).⁹ The majority (around 80 per cent) of the money raised is paid into the NIF from which contributory benefits are financed. The remaining employer contributions (around 20 per cent) part-fund the National Health Service. This notion of ‘funding’ in this context is contentious, see Chapter 8).

10.10 Employers’ NICs do not impact the contributory benefit entitlements of their individual employees, despite being calculated by reference to the individual’s pay.

10.11 The position of an employer as a secondary contributor (someone who is liable to pay Class 1 secondary NICs), makes them legally responsible for the payment of employees’ NICs and Employers’ NICs,¹⁰ and for the collection of student loan repayments. Student loan repayments, deducted by the employer, are based on the earnings that attract Class 1 secondary NICs,¹¹ though, perhaps inevitably, with a different threshold (£331 per week). Secondary contributors are also responsible for administering and part-financing statutory payments such as Statutory Sick Pay and Statutory Maternity Pay. Any changes to employers’ NICs could therefore have consequences for employers’ responsibilities as a secondary contributor.

The case for change

10.12 The remainder of this Annex sets out the case, and broad possible options, for simplifying Employers’ NICs. This could happen in the context of simplifying Employees’ NICs to operate on an annual and aggregated basis (as proposed Chapter 9) or as a standalone change.

Views expressed to the OTS

10.13 The evidence from our meetings suggests that employers’ NICs adds little additional administrative burden to operating employees’ NICs. This is because they:

- are calculated on the same earnings period basis as Employees’ NICs
- are based on the same earnings as employees’ NICs, and
- are paid in parallel with employees’ NICs payments through PAYE¹²

10.14 Employers’ NICs are described in various pejorative ways, ‘a tax on jobs’, ‘simply a payroll levy’. There was no acknowledgement, suggesting either no knowledge or understanding, that employers might have a particular role in relation to the social security regime. Some made the point that employers’ NICs are different in kind from employees’ NICs and so there is no need for them to be aligned in scope. There was disquiet that employers’ NICs are an easy option to

⁹ Report by the Government Actuary, 1/2016, www.gov.uk/government/uploads/system/uploads/attachment_data/file/494930/53430_GA_UpRating_Report_2016_Accessible.pdf

¹⁰ SSCBA 1992 Sch 1 para 3(1)

¹¹ SI 2009/470 The Education (Student Loans) (Repayment) Regulations 2009

¹² These factors are the same as those articulated in research into small employers conducted by TNS UK Limited for HMRC in 2012. www.gov.uk/government/uploads/system/uploads/attachment_data/file/344815/report225.pdf

increase when funds are required as they are a 'hidden' tax and corporate taxpayers have no vote. Some employers feel it is important that employees should know what tax the employer bears in relation to employment, and some go further still and put this information onto payslips. It was suggested that recent changes in taxes concerning employment (for example, the introduction of the Employment Allowance and the Apprenticeship Levy) represent a recognition of a need for change.

Discussion

10.15 The simplification issues related to the **administration** of employers' NICs are unlike other aspects of IT and NICs alignment. There is of course no equivalent IT charge. Turning the focus to differences between employers' NICs and employees' NICs these are few, so that even though the calculation of employees' NICs is complex, employers' NICs does not double the complexity. For almost all employers, software deals with the calculations required.

10.16 The operation of the current employers' NICs could become more of a burden if employees' NICs move away from operating on an earnings period basis. Even if employees' NICs is not changed some argue that the current distortions caused by aspects of employers' NICs (see below) should be addressed by changing the structure of employers' NICs.

10.17 Some straightforward simplification is possible within the current structure. Alignment of the Primary Threshold (currently £155 per week) with the Secondary Threshold (currently £156 per week) would cost £130 million.¹³ A more radical change would be to remove the Secondary Threshold in favour of a flat rate.

10.18 We have not pursued any ideas around removing employers' NICs altogether and instead raising the required funds from employees' NICs, IT or other routes. While this could be a major simplification, it would also involve a significant structural shift in the incidence of taxation, which is beyond our remit to consider.¹⁴

10.19 There are arguments to reform employers' NICs on the grounds of **transparency and economic distortions**. Some of the evidence we received was strongly of the view that employers' NICs are invisible to employees and little understood by them. Employers' NICs contribute to an employer's total cost of employment but are not required to be shown on the employee's payslip.¹⁵

10.20 Some respondents in our meetings have suggested 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. An example mentioned was that an employer taking on an employee for 16 hours per week at the National Minimum Wage would not have to pay employers' NICs on the wage and the employee would remain eligible to receive certain benefits. Employers can reduce the amount they pay in employers' NICs by employing a larger number of part time workers, whose earnings do not breach the threshold, rather than a smaller number of full time workers for whom employers' NICs would be payable. We have not seen direct evidence on the extent to which the Secondary Threshold influences employer decisions.

¹³ HMRC Direct effects of illustrative tax changes, November 2015

¹⁴ Some respondents have suggested that the removal of Employers' NICs would be a major boost to employment, but we are not aware of the extent to which the impact of raising the same funds by other means have been built into this initial view. In contrast, others suggested removing Employees' NICs and building it into Employers' NICs.

¹⁵ During our Employment Status project, some commentators expressed concern that showing employers' NICs on payslips would cause confusion and in some cases were evidence of bad practice among hirers who 'charged' employees for the employers' NICs. It does seem to be an important presentational point.

Options for simplification of employers' NICs

10.21 This section explores possible alternatives to simplify employers' NICs in conjunction with the simplification of the definitions of earnings and of the assessment period set out in earlier recommendations. The full scope of possibilities is broad, some are shown in Table 10.A.

Table 10.A: Summary options to simplify employers' NICs

| Options | Employees' NICs | Employers' NICs |
|----------------|--|---|
| Current regime | Earnings period, per job | Earnings period, per job |
| A | Annual, cumulative and aggregated, NICs code | Earnings period, per job |
| B | Annual, cumulative and aggregated, NICs code | Annual per job, with employee allowance |
| C | Annual, cumulative and aggregated, NICs code | Payroll flat rate, with employer credit |

Option A: Employers' NICs continues to operate on an earnings period basis

10.22 Employers' NICs would continue to be calculated on an earnings period basis, per employment, with a Secondary Threshold for each employee. There would be no need to change the way that employers have to administer statutory payments or collect student loan repayments. Class 1A and Class 1B would remain in place, subject to any changes in the treatment of benefits in kind as set out in Chapters 4 and 11. The existing anti-avoidance aggregation rules to prevent contract splitting would remain.

10.23 While employees' IT and employees' NICs would be more closely aligned on an annual and aggregated basis, employers' NICs would need to be calculated separately, using different rules on an earnings period basis. The system would feature an annual allowance for employees for employees' NICs and (as now) an earnings period threshold per employee for employers' NICs.

10.24 This option retains the familiarity of the current system and the employer would have the advantage of the finality associated with an earnings period basis. However a new misalignment is introduced between the annual basis for employees and the earnings basis for employers. A more significant criticism is that the distortions created by the current system would remain as there would still be a threshold for each employee before employers' NICs becomes due.

Option B: An annual basis for employers' NICs

10.25 With this option employers' NICs would be reformed at the same time as employees' NICs to operate on an annual basis. The Secondary Threshold (currently £156 per week) would be changed to an annual allowance (£8,112 for 2015-16).

10.26 Unlike employees' NICs under option C in Chapter 9, employers' NICs would not be aggregated across employments. The annual secondary allowance would be applied separately to each employment (as it is now). This is because aggregation takes account of other employments (concurrently or consecutively) and there is no fair way of allocating the secondary allowance between employers.

10.27 For employees joining or changing employments part way through the year the annual secondary allowance would be applied pro rata to each employment based on the duration of the employment (in order to prevent an employer benefiting from a full annual threshold with every change of employment). For example, an employer would assess employers' NICs for a

whole tax year, or for the length of the employment if less than a year, with the secondary allowance adjusted pro-rata. The system could work in the same way as PAYE, with employers assessing their liability for employers' NICs on a cumulative basis over the course of the year, or, if earlier, when the employment ends.

10.28 The main benefits of an annual system of employers' NICs are likely to be that:

- employers would benefit in situations where their employees' earnings fluctuated around the Secondary Threshold during the period of employment. Should an employee's earnings fall below the monthly equivalent of the annual secondary allowance the employer would benefit from being able to reclaim some of the employers' NICs paid in earlier periods, or pay less in a later period, and
- employers would not need to attribute earnings to specific earnings periods. Should an under or over payment of earnings be identified, an employer could correct for that in the next pay period without having to go back and correct the amount of Class 1 secondary NICs paid in the previous period

10.29 Anti-avoidance rules are also likely to be necessary to prevent manipulation of employment start and finish dates to increase the duration of employment artificially in order to benefit from a higher pro-rata annual secondary allowance. It would also require the same aggregation rules as exist now to prevent contract splitting.

Option C: payroll flat rate, potentially with employer credit

10.30 Class 1 secondary NICs and Class 1A NICs could be replaced with a charge based on employers' overall remuneration costs. This reform would be pursued alongside employees' NICs operating on an earnings period or an annual, cumulative and aggregated basis (see Chapter 9).

10.31 Representations have suggested this would be viewed as a significant simplification, being:

- easier to calculate
- better understood by employees fit with a move to an annual, cumulative and aggregate basis for NICs

It would, though, conclusively break the link between the way employees' NICs and employers' NICs are determined.

10.32 This section outlines how possible remuneration charges could work, basing the charge on employers' total remuneration costs or payroll. The views presented to us on this were expressed in general terms and did not extend to particular models.

10.33 A charge on total remuneration would mean moving from the current system, where employers' liability to Class 1 secondary is determined at the level of the individual employee, to one where liability is based on all earnings and benefits paid by an employer to individuals in the UK's National Insurance system. A remuneration charge would also replace Class 1A NICs on benefits in kind if the proposal in Chapters 4 and 11 is adopted. A total remuneration charge would operate on an annual basis.¹⁶ Receipts would continue to contribute to the NIF and the NHS.

10.34 The main advantage of a remuneration charge would come from its greater simplicity – both in terms of understanding it and operating it. An employer should, in most cases, only

¹⁶ As discussed earlier, this approach could be introduced with the current earnings period basis for Employees' NICs.

need to know their total employment costs for UK insured employees. The starting position for the definition of earnings would be to match the definition of earnings used for assessing employees' NICs. To ensure that any remuneration charge is fully compatible with EU treaties and the UK's obligations under bilateral Social Security agreements a remuneration charge (as with the current employers' NICs) would not be applied to the earnings of individuals who are outside the UK's National Insurance system.

10.35 The simplest model for a remuneration charge would be a flat rate charge on employers' total remuneration costs. Moving to a flat rate charge would affect some employers' overall liability, compared with the current system. The impact on the employer's liability would depend on the earnings profile of the workforce, while the wider economic impact would depend on whether employers passed on any change in costs.

10.36 Some have argued that a straightforward fixed rate would discourage employment by removing the current incentive of the Secondary Threshold. As mentioned before there is a concurrent concern that this encouragement works by incentivising low pay and encouraging the fragmentation of jobs.

10.37 A deductible allowance at the level of the employer (rather than based on the number of employees) could ensure that an element of incentive remains without the current distortionary impact. The notion of an allowance against the employers' NICs liability was introduced in 2014. The Apprenticeship Levy (to be introduced in April 2017) will also have an allowance, in this case set at a level (£15,000 allowance; 0.5% tax rate) where a pay bill of £3m would be exempt.

10.38 It would clearly be desirable if:

- the pay bill definition for employers' NICs was the same as the definition for the Apprenticeship Levy and
- the credit for each tax exempts the same size of pay bill

Impact of a flat rate tax

10.39 Based on the limited information available to us a flat rate in the region of 10% with no allowance would deliver broadly the same expected employers' NICs proceeds for 2016-17 as are forecast for the present structure of employers' NICs. To the extent that allowances are built into the structure that rate would increase.

Table 10.B: Examples of the implications of different flat rates, combined with allowances, raising the same funds as the current employer NICs regime.¹⁷

| Flat rate | Employer allowance | Implied employer paybill which would not incur a liability | Number of employers with no liability | Number of employers with a liability |
|-----------|--------------------|--|---------------------------------------|--------------------------------------|
| 10% | Nil | N/A | Nil | All |
| 11.5% | £115,000 | Up to £1m | 1.51m | 40,000 |
| 13.5% | £675,000 | Up to £5m | 1.54m | 10,000 |

10.40 The impact of a flat payroll based tax, compared with the current employers' NICs charge, is likely to vary between different economic sectors, depending on the composition of the workforce (for example, whether employees tend to be part time or full time workers, or more

¹⁷ These figures have been computed by the OTS and are based on information provided by HMRC relating to the employer population in 2012-13. They are intended to illustrate that this type of tax structure can deliver simplification for a considerable population.

highly paid or lowly paid) and the balance between capital investment and labour. To the extent that there is a gender bias connected with any of these differences (for example, part time work and women), that may also be reflected in the impact of moving to a flat payroll based tax.

10.41 These impacts could be reduced, to some extent, if an allowance was introduced. For example, smaller businesses would benefit but businesses with a large number of employees may pay more tax compared with the present, as the savings they would make from an allowance would not offset losing the secondary threshold.

Options for simplification of Employers' NICs – initial assessment against objectives

Table 10.C: Table summarising options for the simplification of employers' NICs, against simplification objectives

| Objective | Option A – employer NICs operates on an earnings period basis | Option B – employer NICs operates on an annual basis | Option C – payroll flat model for employer NICs |
|--|---|---|--|
| Reduce compliance burdens for taxpayers and employers | Increases complexity by introducing a new misalignment within NICs, however the familiarity of Employers' NICs would be retained. | Employers' NICs would move onto an annual but still quite different basis to Income Tax. A new concept, of pro-rating annual allowances, would be introduced into the tax system. | This could potentially reduce employer burdens, but will depend on the precise model for the charge. |
| Remove distortions | No impact | Potentially introduces an incentive to manipulate employment start and end dates. | Removal of secondary threshold would remove distortions. |
| Reduce administrative costs for HMRC | No impact | Potential compliance risk around manipulation of employment start and end dates could increase HMRC's costs. | Likely easier to check compliance, but HMRC query this. |

10.42 We recommend Option C: a single flat rate charge applied to whole payroll costs, with the liability potentially reduced by a fixed allowance for each employer. We propose that this is introduced concurrently with an annual, cumulative and aggregated basis for employees' NICs. We consider this will take five years to deliver (see Chapter 2).

10.43 Although employers' NICs could be changed in isolation before employees' NICs, there are no merits in having a prolonged period of change. However, if employees' NICs are not reformed onto an ACA basis, the move to a payroll based Employers' Social Contribution could go ahead separately.

Transparency

Information on employers' NICs provided to employees

10.44 Some respondents suggested that putting information about employers' NICs onto employees' payslips would increase the transparency and understanding of NICs. Some employers do this already. We understand this is often so that employees of umbrella companies are made aware of the employers' NICs cost which their engager has funded from the

employee's own pay.¹⁸ No reasons were given why employers' NICs should be distinguished in this way from other costs of employment (and indeed other taxes borne by employers). Introducing more information onto payslips has the potential to confuse rather than clarify.

10.45 If employers' NICs remain unchanged so that the amount paid is directly related to the pay of each individual employee, the figure to put onto the payslip is straightforward. However, the administrative costs of changing payroll systems to effect this may not be justified if the aim is simply to achieve greater transparency. Nothing prevents individual employers from providing this information if they wish.

10.46 If, as we recommend, the link with individual pay is broken and employers' NICs moves to a system based on the overall payroll size, it would run counter to the overall simplicity of the new approach to then compute a notional employee amount simply in order to disclose the sum on each payslip. The administrative difficulties would increase further if an employment credit was applied.

Should employers' NICs be re-branded?

10.47 There was some concern amongst our respondents that employers' NICs (and its formal version of Class 1 secondary National Insurance Contributions) is simply a misnomer, that the tax is just a payroll tax and should be called that. This links to issues such as whether the tax ultimately falls on the employer at all or is in fact passed on to employees.

10.48 However, while employers' NICs has no impact on the benefit entitlements of individual employees, the major part of proceeds of this tax goes into the NIF so the term 'employers' NICs' does not seem completely wrong. On the other hand, renaming it would eliminate the NICs aspect of the name, something that would no longer be appropriate with the revised basis we recommend.

10.49 The current name appears in many of the UK's social security double contribution agreements so any change will require careful management to ensure that these agreements are not disturbed.

Related issues

10.50 As noted earlier, the position of an employer as a secondary contributor carries additional responsibilities. Any significant reform of employers' NICs may require consequential changes to the rules for the collection of student loan repayments and the administration of statutory payments.

Recommendations

Employers' NICs model

10.51 From a simplification point of view a flat rate model with the potential for an employer credit is the route we prefer. We recommend that the OTS fully explores the impact on individuals and businesses of a move to a payroll based charge, and sets out a detailed path to implementation.

10.52 Introduction of such a model should be concurrent with an annual and aggregated approach for Employees' NICs.

¹⁸ 'Umbrella companies' are an employment mechanism often used for engaging contractors. The pay rate received by the contractor directly reflects the Employers' NICs paid by the employer. Economists would argue that Employers' NICs are always borne by employees, even if not stated overtly.

Transparency

10.53 We recommend that the new Employers' NICs model should be re-named. We have no firm views on the new name but suggest 'Payroll levy' as a holding title.

Discussion: aligning the tax bases for employees

11

11.1 This chapter provides further background information on the misalignments and concepts described in the recommendation summaries in Chapter 4.

The scope of the charges

Box 11.A: The different definitions of earnings for IT and NICs for the employed

Income Tax – Section 62 ITEPA 2003

62(1) This section explains what is meant by ‘earnings’ in the employment income Parts.

62(2) In those Parts ‘earnings,’ in relation to an employment, means–

- any salary, wages or fee,
- any gratuity or other profit or incidental benefit of any kind obtained by the employee if it is money or money's worth, or
- anything else that constitutes an emolument of the employment.

62(3) For the purposes of subsection (2) ‘money's worth’ means something that is–

- (a) of direct monetary value to the employee, or
- (b) capable of being converted into money or something of direct monetary value to the employee.

62(4) Subsection (1) does not affect the operation of statutory provisions that provide for amounts to be treated as earnings (and see section 721(7)).

National Insurance – Section 3 SSCBA 1992

3(1) In this Part of this Act and Parts II to V below–

- (a) ‘earnings’ includes any remuneration or profit derived from an employment; and
- (b) ‘earner’ shall be construed accordingly.

11.2 It is generally accepted that the definition of earnings for NICs purposes is broader than the definition for IT, with ‘remuneration or profit’ encompassing more than ‘emoluments’. Opinion is divided on whether the earnings definition for NICs includes payments in kind. It could be said that HMRC considers the definition somewhat broader than advisers and commentators do.

11.3 There is a far greater number of cases to refer to for IT than for NICs on the subject of ‘earnings’. Unfortunately the case law for IT is at best only indicative when it comes to NICs.

11.4 The relatively recent National Insurance decision of the Supreme Court in *Forde and McHugh*, brought the differing definitions of earnings into focus.¹ The case considered the transfer of treasury stock and cash into a funded unapproved retirements benefit scheme (FURBS). The transfer was not earnings for IT purposes under section 62, but was taxable as specific employment income under section 595 ICTA 88. The IT position was therefore not in question. The case focused on whether the transfer constituted earnings for NICs purposes. The taxpayer could not rely on the accepted position that it did not fall within the definition of earnings for IT purposes. The Supreme Court focused mainly on the contingent nature of the payment and determined that the payment was not earnings for NICs. However, in its decision the Supreme Court held that ‘earnings’ in NICs legislation does not equate to ‘emoluments’ in IT legislation.

A comparison of the IT and NICs legislation

11.5 A common complaint is that there is a need to go through two completely different routes within the legislation to determine the IT and NICs treatment. There are time costs for employers, individual taxpayers and HMRC in having to identify the separate IT and NICs treatment of payments, benefits, expenses etc. Unifying the two as much as possible would reduce these time costs.

11.6 As an example, consider non-cash vouchers such as vouchers for a high street store given to an employee by their employer:

- For the IT treatment, as well as containing the basic definition of ‘earnings’ as set out in section 62, later Chapters in Part 3 ITEPA 2003 treat certain benefits as earnings. Non-cash vouchers are not earnings under section 62 as they are not ‘money’s worth’, but it is clear from section 82 that they may be taxable. One still needs to check that there is not an applicable exemption, by looking at the exemptions in section 266 in Part 4 ITEPA 2003. It requires further reading to work out from the legislation whether the vouchers are reportable on Form P11D or are subject to PAYE
- Working out whether non-cash vouchers are subject to NICs takes a completely different legislative route. Non-cash vouchers fall within the definition of ‘earnings’ under section 3 SSCBA. However, there is still a need to refer to the National Insurance regulations in SI 2001/1004, in particular Schedule 3. Part II of Schedule 3 sets out that certain payments in kind are to be disregarded. It says that non-cash vouchers are not to be disregarded if they are not of a description mentioned in Part V or to which paragraph 4 of Part X applies. Retail vouchers are not in a category that can be disregarded and are therefore subject to Class 1 NICs

This is a lot of work and reading for one enquiry.

Specific employment income – termination payments and the current consultation

11.7 Termination payments are taxable to the extent that they exceed £30,000 and are wholly exempt from NICs. They fall within Part 6 ITEPA 2003 as ‘specific employment income’, without any corresponding provision in the NICs legislation. The differing IT and NICs treatment does pose a complication for employers, but before they reach that stage they need to work out what elements of a payment are earnings under section 62 ITEPA and section 3 SSCBA. Putting it simply, payments that are paid under the employment contract or can be implied into the

¹ *Forde & McHugh Ltd v Commissioners for HM Revenue & Customs* [2014] UKSC 14

contract are subject to IT and NICs as earnings. Following an earlier OTS review and recommendations the IT and NICs treatment of termination payments is currently the subject of consultation and review.² The consultation document contains a range of proposals including aligning the IT and NICs treatment of Part 6 termination payments. It should be noted that an anticipated consequence of alignment would be a reduction in the gross termination payments made to employees as employers try to recover the additional secondary Class 1 NICs. This would reduce the amount of IT payable and also the net payments to the employees (unless the £30,000 threshold is increased). There would be an exchequer impact which would need to be understood. The impact would be delayed as you would expect employers to bring forward some redundancy payments to avoid the NICs charge.

Expenses, deductions and other reliefs

Approved Mileage Allowance Payments (AMAPs)

11.8 AMAPs are the approved mileage rates for employees using their own cars for business. We expand below on the points made about them in Chapter 4 of this report.

11.9 We mention there that two different rates apply for IT, 45p per mile for the first 10,000 business miles and 25p per mile thereafter.³ Only one rate, 45p per mile, applies to all business mileage for NICs. Aligning the rates either way would be a simple alignment. The simplest alignment would be to have one rate for both IT and NICs. However, the policy intention of having a lower rate after the first 10,000 miles for IT purposes should be noted. The higher rate is to cover fixed costs such as insurance which are not covered by the lower 25p per mile rate.

11.10 We described in Chapter 4 how employees who are not in receipt of mileage payments from employers for using their own cars for business can claim a tax refund based on AMAP rates but cannot claim a NICs refund.

11.11 While considering the IT and NICs difference with regards to AMAPs, we should consider the issue of car allowances and AMAPS and the high profile case *Total People*⁴. Some employers choose to pay their employees a car allowance and then reimburse for business mileage at rates lower than AMAPs. Of these some have taken the approach that the car allowances are 'Relevant Motoring Expenses' (RME) as prescribed in the NICs regulations.⁵ RME payments are treated as earnings for NICs but only to the extent that they exceed the Qualifying Amount (QA). The QA is essentially the employee's business mileage multiplied by the AMAP rate of 45p per mile. These employers make deductions for business mileage from the monthly instalments of car allowances before applying IT and NICs.

11.12 Some employers did not take this approach initially and made claims to HMRC for Class 1 refunds on the QA element of the car allowances on the basis that they made an error. These employers keenly followed the journey of *Total People* to the Court of Appeal, where it was decided that the car allowances were designed in order to prevent staff making a personal profit by maximising their travel on a 40p per mile basis and were therefore not earnings for NICs. This decision was a good outcome for the appellants, but has not necessarily brought resolution for those other employers who have made claims. The Court of Appeal when handing down its decision in *Total People* declined to opine on whether the employer had met the conditions of regulation 22A(3) which determine whether a payment is RME.

² www.gov.uk/government/consultations/simplification-of-the-tax-and-national-insurance-treatment-of-termination-payments

³ Sections 229-230 ITEPA 2003

⁴ www.bailii.org/ew/cases/EWCA/Civ/2012/1429.html

⁵ Regulation 22A SI 2001/1004

11.13 There is clearly scope to align the NICs treatment of business mileage to IT, especially if NICs were to be calculated on an annual basis. This could avoid any further strain between employers and HMRC.

Give As You Earn (GAYE) and Gift Aid

11.14 In simple terms GAYE and Gift Aid attract IT relief but not NICs relief. We have not received reports that misalignment between IT and NICs for Gift Aid and GAYE is causing complexity or difficulty and it has not been raised as a fairness issue. For now we would mark the misalignment in the IT and NICs treatment of charitable donations as a low priority.

11.15 In 2014-15 provisional figures indicate that 1,094,000 people donated £126 million through the payroll (a slight reduction on 2013-14).⁶ By making the donations through the payroll the donations were deductible against their taxable income and the tax relief on these donations cost the exchequer £40 million. No corresponding NICs relief was available on their donations. So the IT and NICs treatment of GAYE donations are not aligned, but to some extent they are aligned against the treatment of Gift Aid donations. As mentioned in Chapter 4 Gift Aid is relief against all income, not just employment income. Donations via Gift Aid are on a different scale to GAYE. Donations via Gift Aid, before tax relief, totalled £4,190 million in 2013-14 and are expected to have risen to £4,780 million in 201-15⁷. The mechanism through which tax relief is given under Gift Aid is different for GAYE, but again there is no NICs relief.

11.16 As a policy point, ministers may wish to consider whether introducing NICs relief would increase donations, particularly from those people who are paying the higher rate of Class 1 NICs. However, this would require the introduction of more administration in the form of NICs refund claims, whereas now only higher and additional rate payers are currently applying for tax relief through self-assessment or amendments to their PAYE codes. Our ACA proposals, together with the NICs code idea, could facilitate this. For Gift Aid the additional complication of it being a relief against all income would need to be taken into account. Alignment in one area could create complexity elsewhere.

Benefits in Kind (BiKs)

Introduction of Class 1A NICs

11.17 Liability to IT was imposed in 1948 on BiKs which do not represent money or money's worth. It was not until 1991 that NICs liability - in the form of Class 1A NICs - was imposed on such benefits, and even then the liability was limited to the provision of company cars and fuel for private motoring in such cars. Class 1A contributions were introduced 'to fill...an important gap in the NICs system, as a result of which employers did not make contributions to the National Insurance fund if they paid their employees in cars rather than in cash' (Hansard 9 May 1991 col. 849). Since 1991 the ambit of Class 1A NICs has been gradually extended so that from 6 April 2000 all taxable benefits are subject to Class 1A NICs unless they are either liable to Class 1 NICs (eg vouchers) or are included in a PAYE Settlement Agreement (where Class 1B applies – see below).

11.18 Class 1A NICs are payable by the employer on 19 July following the end of the year of assessment. Where payment is made electronically the time limit is extended to 22 July. The Class 1A rate is the standard secondary Class 1 contribution rate for the tax year in which the

⁶ www.gov.uk/government/uploads/system/uploads/attachment_data/file/456121/Table_10_8.pdf

⁷ www.gov.uk/government/uploads/system/uploads/attachment_data/file/456115/Table_10_3.pdf

benefit is provided. There is no reduction where the employment is contracted-out or the employee is under the age of 21.

Discharge of Pecuniary Liabilities

11.19 Where an employee receives from his employment a benefit or advantage which is not money but which represents money's worth, that benefit or advantage is taxable earnings. 'Money's worth' means that the benefit or advantage is capable of being converted into money. The 'money's worth' principle was established for IT at an early stage in *Tennant v Smith*.⁸ The principle was then developed in *Hartland v Diggins* where the courts ruled that an employer's discharge of an employee's personal indebtedness to a third party - in this case IT - represented taxable earnings from the employment.⁹ The principle was developed further in the NICs context in *R v DSS ex parte Overdrive Credit Card Ltd* when Lloyd LJ observed in giving judgement "The right approach is to regard the discharge of an employee's debt as the equivalent of a payment in cash..."¹⁰

11.20 This means that any such discharge of a pecuniary liability is earnings for the purposes of Class 1 NICs. By contrast, where a benefit or advantage from the employment is not capable of conversion into money it is not earnings for the purposes of Class 1 NICs. Rather, it is a payment in kind and, unless exempt from IT and disregarded for NICs, it is liable to Class 1A NICs. Accordingly, when the employer pays a debt, and doing so advantages or benefits the employee, it is vital for NICs purposes to establish the identity of the debtor. That in turn involves identifying the person who made the contract under which the indebtedness arose. If it was the employer, the payment of the debt confers a benefit in kind taxable under the benefits code. If however, the employee made the contract the payment of the debt is the discharge of a pecuniary liability and so constitutes earnings taxable without reference to the benefits code.

11.21 It can often be both difficult and time-consuming to establish who made the contract, and complexity is increased when the goods or services are paid for using a company credit card. Where the employee tenders the card before the goods or services are supplied, making clear to the supplier that he is acting on behalf of the employer and the contract proceeds on that basis, the goods or services belong to the employer from the outset. Assuming that the goods or services have not been supplied for business purposes, if the employer does not require the employee to reimburse the costs then the goods or services constitute a BiK and there are no earnings for the purposes of Class 1 NICs. The value of the BiK does however give rise to a liability to Class 1A NICs.

11.22 By contrast, where the employee does not make it clear before the goods or services are supplied that he is acting on behalf of the employer, and simply tenders the card once delivery of the goods or services is complete, the result of the purchase is that the goods or services become the property of the employee. If the employee does not reimburse the employer, the employer's settlement of the credit card indebtedness represents the discharge of the employee's pecuniary liability which constitutes earnings for the purposes of Class 1 NICs (see *R v DSS ex p. Overdrive Credit Card Ltd*). In meetings, employers readily admitted that they were unsure whether employees followed the proper route – many saying that they probably didn't and that it was in any event simply impractical.

11.23 If all taxable BiKs were brought into Class 1 NICs and Class 1A abolished, this problem would disappear.

⁸ (1892) 3TC 158

⁹ (1926) 1-TC 247

¹⁰ [1991] STC 129

Payrolling BiKs

11.24 Since 1948 (see above) the PAYE Regulations have prescribed that the employer shall make an annual return on form P11D of the taxable benefits provided to each individual employee. The IT due on the benefits is then collected either by adjustment to the employee's PAYE Code or through self-assessment.

11.25 Some employers, with the agreement of HMRC, have been able to payroll some of their benefits. 'Payrolling' is the process whereby the value of a taxable BiK is charged to PAYE as part of the normal process as if it were salary. Class 1A NICs is still paid after the tax year. There was no legal cover in the PAYE Code for payrolling benefits.

11.26 The OTS in its Second Report (January 2014) on the Review of employee benefits and expenses recommended the introduction of a legislative framework to permit employers to payroll some or all of their employee benefits. The government accepted this recommendation and the necessary legislation is contained in s17 FA 2015 and SI 2015/1927. Voluntary payrolling of benefits under this regime will begin from 6 April 2016.

PAYE Settlement Agreements (PSAs)

11.27 A PSA allows an employer to make one annual payment to cover all the IT and NICs due on employees' taxable expenses which are minor or irregular, or where it is impractical to apply PAYE or to work out the value of the relevant benefit. An item which is included in a PSA does not need to be put through payroll or included on a P11D and no Class 1 or Class 1A NICs will be due on it as the employer pays Class 1B NICs as part of the PSA instead.

11.28 Class 1B NICs are charged on the value of all benefits contained in a PSA and also on the (grossed up) IT on those benefits. The tax has to be grossed up because the payment under the PSA is itself a benefit which would not otherwise be charged to tax on the employee.

11.29 All liabilities, both IT and NICs, under a PSA are payable by 19 October following the end of the year to which the PSA relates. Where payment is made electronically the time limit is extended to 22 October. The Class 1B rate is the standard secondary Class 1 rate for the tax year in which the benefits were provided. There is no reduction where the employment is contracted-out or the employee is under the age of 21. The total Class 1B paid in respect of 2014-15 was £226 million, significantly less than the Class 1A total of £1.1 billion.

11.30 Some people suggested that Class 1B NICs should be replaced by a Class 1 NICs charge. We are not recommending this, for administrative reasons. Two of the conditions which must be satisfied if an item of earnings is to be included in a PSA are that it is impractical to operate PAYE or to apportion a shared benefit between the individual employees who enjoy the benefit. If PAYE cannot be operated or the value of a benefit for an individual cannot be established, it is clearly impossible to apply a Class 1 NICs charge on the value of a benefit. In addition, the NICs paid through a PSA cannot be allocated to individual employees' contributions records.

11.31 We received many calls for the scope of PSAs to be widened and the processes simplified. We saw these enhancements as offering great scope for simplification, complementing the reforms contained in our other proposals and thus recommended:

- widening the scope of PSAs, for example by allowing all benefits to be PSA'd apart from a set list
- simplifying the procedures, for example by abolishing the need to agree the scope of a PSA in advance

11.32 HMRC rejected these recommendations but our findings in the current project confirm the need for them and that employers' desire for them continues to be the case. We therefore repeat our call for a general widening of the scope of PSAs.

Introduction

12.1 The Small Business Enterprise and Employment Act was granted Royal Assent on 17 September 2015 and represents a commitment on the part of the UK government to meet the objectives laid out in the UK G8 Action Plan, published after the 2013 G8 Summit. This plan centres on *greater tax transparency*, particularly corporate transparency and beneficial ownership.

12.2 OTS surveys and research reveal many people find the distortions between employed and self-employed Income Tax (IT) and NICs to be confusing and opaque, and many taxpayers do not realise that self-employed people pay a lower rate of NICs and are also not entitled to all contributory benefits see Table 5.A. This is seen by some to be inequitable and unnecessarily complex.

12.3 There is also a ‘third dimension’, concerning the form through which some workers are engaged. A worker may provide services directly or through an intermediary company, in which case the engager pays the limited company for providing services. Many people work through limited companies in order to limit their liability. Some workers provide their services through Managed Service Companies or Umbrella Companies¹. Some intermediary companies may be taxed under the provisions known as IR35 (which applies in situations where, if the intermediary did not exist, the relationship would constitute an employment relationship between the individual and the engager). Workers using intermediary companies may describe themselves as self-employed (reflecting their independence), even though the formal structure indicates that they are employees.

12.4 IR35 is outside the remit of this project and will not be discussed in any detail as it is currently subject to consultation by HMRC²; previous OTS projects such as the Small Business Tax Review of March 2011 have already discussed IR35 in some detail.³

12.5 To allow for employed and self-employed IT and NICs alignment to be discussed in a reasonable degree of detail, it is necessary to consider how they each differ to be able to conclude whether any alignment between the two is possible, viable, equitable and realistic.

12.6 As such, Chart 12.A describes what must be considered, given that the self-employed carry risk and the employed carry employment rights.

¹ ITEPA 2003, ss.48-61; ITTOIA 2005, ss. 148K, 163,164; SI 2000/727; NICA 2014 s.2

² www.gov.uk/government/uploads/system/uploads/attachment_data/file/446242/Intermediaries_legislation_IR35-discussion_document.pdf

³

www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf

Chart 12.A: Relationships between IT and NICs for employed and self-employed people



In this chart:

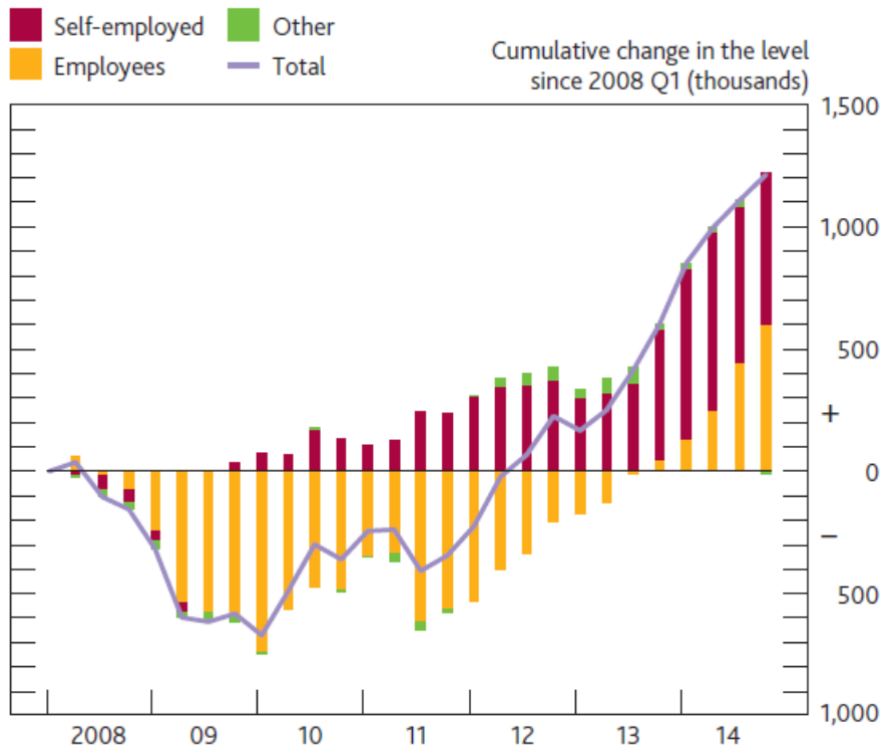
- A) The relationship between IT for the employed and self-employed is deemed outside the scope of this report.
- B) The relationship between IT and NICs for the employed is discussed elsewhere in this report (see Chapters 2 and 4).
- C) The relationship between IT and NICs for the self-employed is discussed in this section.
- D) The relationship between NICs for the employed and self-employed is discussed in this section.

Behavioural drivers for employment and self-employment

12.7 It is also necessary to consider what drives people to be either employed or self-employed. In today's flexible workforce, where the notion of a 'job for life' is virtually non-existent, many people work in consulting roles as well as simultaneously holding employed positions, and many more people now work part-time or have more than one job. This is a major change from, say, 20 years ago. The current level of self-employment reflects an on-going trend, illustrated in Chart 12.B.

12.8 The advantage of engaging someone through an agency or through their own limited company allows the employers paying them to have the benefits of a flexible workforce without the need to consider employment rights and employer's NICs. Aligning IT and NICs for the employed and self-employed may therefore affect the drivers for becoming self-employed and the structure through which the self-employed offer their services, whether that driver is set in motion on the initiative of the individual, or the business engaging the individual.

Chart 12.B: Change in total employment since 2008 Q1



Source: LFS.

(a) The 'Other' category includes those in government-supported training and employment programmes as well as unpaid family workers.

Source: (from Bank of England Quarterly Bulletin 2015 Q1)

12.9 HMRC has for some time been concerned with 'false self-employment' whereby people who would otherwise have been engaged under a contract of employment have deliberately been placed on a self-employed basis, notwithstanding that if the nature of the relationship were to be examined, the conclusion would be that it was one of employment.⁴ (The individual may of course be working through a corporate vehicle of some form.) One of the consequences of this is that, very often, people are simply not aware that if they become 'self-employed' and do not use a corporate vehicle, they will lose their entitlement to contribution-based Jobseeker's Allowance, which could leave them in a disadvantaged position when the contract comes to an end.

12.10 In the OTS's Employment Status report⁵ we noted that a significant growth area is where people have both employment and self-employment. That naturally causes difficulty and confusion over the differing NICs treatments.

⁴ The 2014 Finance Act amended s44 ITEPA 2003 in measures designed to tackle False Self Employment: preventing employment intermediaries being used to avoid employment taxes and obligations by disguising employment as self-employment.

⁵ <https://www.gov.uk/government/publications/employment-status-review>

Table 12.A: The following table highlights some of the main differences between employed and self-employed workers (also illustrating personal services company position (PSC))

| | Employed individual £ | Self-Employed individual £ | Personal services company £ |
|--|--------------------------|-------------------------------|--------------------------------|
| Remuneration/Profit | 65,000 | 65,000 | 65,000 |
| Expenses * | 5,000 | 5,000 | 5,000 |
| Personal Allowance | 11,000 | 11,000 | 11,000 |
| Taxable Income | 54,000 | 49,000 | 51,888 in PSC |
| Salary paid by PSC | n/a | n/a | 8,112 |
| Dividend paid by PSC | n/a | n/a | 41,510 |
| Income Tax | 15,200 | 13,200 | See below |
| Corporation tax | n/a | n/a | 10,378 |
| Class 1 NICs | 4,633 | n/a | 6 |
| Class 2 NICs | n/a | 146 | n/a |
| Class 4 NICs | n/a | 3,485 | n/a |
| Income Tax on dividend | n/a | n/a | 4,178 |
| Total Personal Tax and NICs charge | 19,833 | 16,831 | 14,561 |
| Net position for individual after tax and expenses | 40,167 | 43,169 | 45,439 |
| Employer's NICs | 7,851 | n/a | 0 |

NB: these tax outcomes are based on 2016-17 rates and allowances

* Expenses (travel to work) not deductible for employee

Views expressed to the OTS

12.11 Most of the discussion around the possibility of alignment of employed and self-employed NICs centred on whether the rates and thresholds could or should be aligned. Opinion was split between those whose opinion was that a lower rate of Class 4 (compared with Class 1) was the reward for taking business risks in the world of self-employment, and those who felt the self-employed were being discriminated against as they were not entitled to the full range of contributory benefits as a result of paying less NICs. A slight majority did however feel that the alignment of rates and thresholds would be a feasible and sensible simplification to what is seen by taxpayers as a complicated and little understood area of taxation. A selection of respondents put forward the suggestion that two levels of NICs should be applied across the board for all individuals, regardless of employment status. Tier 1, of say, 8% would give a basic entitlement to state pension and NHS and Tier 2 would be a voluntary contribution which would entitle the individual access to state welfare benefits.

12.12 The fact that most taxpayers appear to be unaware that employed and self-employed individuals pay different rates of NICs at different thresholds illustrates the lack of general knowledge around NICs by the public.

12.13 Representations were also made that it should be much easier to obtain NICs refunds than it currently is and that those taxpayers who try to claim need to understand a very complicated and lengthy process to get their money back. What is not clear is the value of refunds paid out in total in any year and whether this area merits the efforts of simplification - further research needs to be undertaken.

12.14 The Categorisation regulations are widely seen as illogical and outdated but concerns were expressed about changing them. This is partly because they are well known and understood in the affected industries; partly because of potential adverse impact on some low paid (though this of course depends on how the change is made).

12.15 One of the biggest concerns expressed was around the amount of people who appear to have been coerced into being engaged through a limited company of which they are the sole director, or other intermediary such as a Managed Service Company or Umbrella Company. There were many concerns expressed about the individuals' lack of understanding of their IT and NICs position. There are obvious concerns about the exchequer impact as well.

Income Tax (IT)

What items are treated as 'income' for employed and self-employed individuals?

12.16 There are considerable differences between what is taxable for the employed and self-employed, but these are outside the scope of this project and therefore will not be discussed in this report.

12.17 Suffice it to say that for IT purposes, an item must have the 'quality of income' to be categorised as such, but there are instances where capital receipts are required to be treated as income.^{6 7}

12.18 Thus, in addition to what people commonly think of as income such as salary / wages and profits, there are other items which are also treated as income even where they appear, on the face of it, to be capital in nature.

Exempt income

12.19 The most notable exemptions from IT are as follows:

- there is a special exemption for low income employees meeting certain conditions, eg seasonal migrant workers working in service or agricultural sectors whose overseas income for the tax year is taxed in the other jurisdiction
- overseas forces personnel (including civilians) who are not British citizens are exempt from IT while serving in the UK
- other items are also exempt from IT, such as maintenance payments, re-training expenses, ISA interest and premium bond winnings, educational grants and mis-selling compensation, local council improvement grants, etc.

Who is chargeable to IT?

12.20 Overseas issues are not discussed in this paper - however, for clarity, to be chargeable to IT, a person must broadly be UK resident, whether the income arises in the UK or abroad, subject to special rules for those individuals not domiciled in the UK. Non-residents are chargeable to IT on income arising in the UK.

⁶ ITTOIA 2005 parts 1&2

⁷ Something is said to have the 'quality of income' when upon receipt it becomes the unconditional beneficial property of the recipient

12.21 A statutory residence test was introduced from 2013-14 to clarify whether an individual is resident or non-resident in the UK.⁸ Double taxation relief is available where income is chargeable to tax in the UK and another jurisdiction.

Is 'Income' different for employed and self-employed individuals?

12.22 The main headings under which income is chargeable to IT are as follows:

- employment income, pensions and some social security benefits
- trading income, including profits from trades, professions and vocations
- income from property⁹
- savings and investments which pay interest or forms of bonus

Essentially, this means that IT is charged on profits made by individuals, regardless of employment status, so it is not different.

Income for employed individuals

12.23 Employed individuals pay IT under the PAYE system of collection which is administered by their employer and returned to HMRC under a Real Time Information (RTI) system. Chapters 2 and 4 of this report refers to employed individuals in further detail. In 2012-13, 23.4 million individuals were in receipt of employment income.¹⁰

Income for self-employed individuals¹¹

12.24 Self-employed individuals pay tax on their income under self-assessment, an annual return process which allows for the first half of their IT to be paid in January following the year of assessment and the second half to be paid in July following the January when the first instalment was paid. In 2013-14, 3.5 million individuals paid tax on self-employed income¹² - according to HMRC's 2016 figures, the number of self-employed workers in the UK is now 4.7¹³ million.

12.25 The basis of assessment is that IT is charged on the net income (business profits) generated in that tax year. This applies in most cases apart from opening years and when year ends are changed to the accounting year ending in that tax year.

12.26 This differs from PAYE for employed individuals and does not facilitate a 'pay as you earn' system for the self-employed, which instead runs on an essentially retrospective system of post-accounting assessment.¹⁴

⁸ FA 2013, s.218 and Sch.45

⁹ Held in *Huitson v HMRC* [2015] UKFTT 0448 that for the purposes of s. 858(4) ITTOIA 2005, 'income' can be read as meaning 'profits'

¹⁰ <https://www.gov.uk/government/statistics/earned-income-2010-to-2011>

¹¹ ITTOIA 2005, ss. 196-220

¹² <https://www.gov.uk/government/statistics/earned-income-2010-to-2011> Table 3.6 Profit, Employment and Pension Income 2013-14

¹³ ONS Employees and self-employed by industry: EMP14

<http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/employeesandselfemployedbyindustryemp14>

The self-employed figures in these tables include those who engage through personal service companies

¹⁴ It is worth noting in passing that Universal Credit will mean that self-employed people claiming will have to submit a monthly income/profit statement in some form.

12.27 In addition to this, a small number of employed individuals and pensioners are obliged to complete a self-assessment return to declare other sources of income which are not within PAYE.

12.28 The creation of a regularised payment on account system for the self-employed utilising an interactive Your Tax Account interface would allow self-employed workers to smooth their cash flow and plan their affairs more efficiently. It would also smooth the cash flows into the exchequer. For the first year of trading, the payments on account could be based on forecasts of income and thereafter they could be based on last year's turnover and profit levels, in the same way that payments on account in January and July are now. HMRC are working towards this in the 'Your Tax Account' system.

12.29 Currently, taxpayers can set up direct debits to make payments on account of their forthcoming liabilities. However, this appears to be purely voluntary and is not underpinned by regulations requiring regular payment, and it is not clear as to how widely used a monthly direct debit facility is, or whether the vast majority of direct debits are merely six-monthly.

Calculating taxable income for both employed and self-employed persons (ITA 2007 ss 22-32)

12.30 Taxable income for IT purposes is broadly calculated by adding together amounts to arrive at a total income figure then deducting certain reliefs such as interest paid or trade losses¹⁵ or pension contributions to personal or occupational pension schemes¹⁶ gifts of shares, securities or other investments to charity¹⁷ or gift aid payments¹⁸ to arrive at a net income figure, then deducting the personal allowance. After this, eligible tax reductions such as married couples allowance can be deducted.

12.31 The usual method is to deduct reliefs, allowances and reductions so as to arrive at the lowest possible tax liability for the individual, unless specifically stated otherwise.

NICs

What is 'income' for NICs purposes? Is it different to income for IT purposes?

12.32 The concept of NICs originated and evolved in a different government department to IT and was originally conceived for a completely different purpose - to fund state benefits, pensions and the NHS. People pay NICs on 'earnings' or 'profits' rather than 'income'. However, HMRC is now responsible for the policy, administration *and* collection of both IT and NICs since the Contributions Agency was subsumed into HMRC in the 1990s, meaning that the same government department now runs what are effectively two separate and distinct systems for each impost.

12.33 What is 'income' for NICs purposes is not quintessentially different from 'income' for IT but the terminology used is different, and some of the elements which make up 'income' for each impost are different, which creates confusion and opaqueness.

12.34 It is also worth noting that a further, secondary, difference as far as the self-employed individual is concerned is that while Capital Allowances are deductible in the calculation of

¹⁵ TA 1988, ss.365,369; ITA 2007, pts 2,5, 5B, 6,7,8

¹⁶ FA 2004, ss188-195A

¹⁷ ITA 2007, ss 431-445

¹⁸ ITA 2007, ss 413-430; ITOIA 2005, s 627; SI 2013/938; FA 2015, s 20

profits for IT purposes, they are not utilised in the same way when calculating Class 4 NICs on profits.¹⁹

12.35 For non-corporate Construction Industry Scheme (CIS) subcontractors, the gross payments received are brought into the accounts and the CIS withholding is deemed to be a payment on account of any IT and Class 4 NICs due under self-assessment. Where IT and Class 4 NICs have been overpaid, a repayment claim can be made in the SA return. Repayment claims for those with year ends outside April each year can be made but the repayment is usually delayed until HMRC has carried out checks to ensure the tax calculation is correct before releasing a repayment.

12.36 In spite of this, many contractors view the payment of CIS withholdings to be a convenient payment on account mechanism and would not seek to change it.

Different classes of NICs for the employed and self-employed

12.37 NICs have been created using the notion of ‘Classes’ of contribution, depending on whether the individual is employed, self-employed or paying voluntarily to top up their contributions record, or an employer. Class 1 NICs for the employed are discussed elsewhere in this report and are therefore not duplicated in this section.

Social Security (Categorisation of Earners) Regulations 1978

12.38 The Categorisation of Earnings Regulations 1978 determine whether certain individuals are to be employed earners or self-employed earners for NICs purposes.²⁰ They also remove the fees of some workers from the scope of NICs. What this means is that an individual can have one status for IT and a different one for NICs.

12.39 Part I of the first schedule of the regulations categorises certain types of workers as “employed earners” for NICs purposes, even though they are not normally considered to be employees for the purposes of income tax or employment law. The scope of this part has been reduced in recent years and now applies to certain cleaners and certain individuals engaged via an employment intermediary. This does not imply that the number of people this part applies to is small.

12.40 Conversely, Part II provides that certain types of worker, for example exam invigilators, are treated for NICs purposes only as self-employed, even though for all other purposes the individuals may be treated as employees.

12.41 Finally, Part III provides that the fees of certain types of worker, for example election officers, are wholly disregarded for NICs purposes.

12.42 A list of the occupations affected by the categorisation regulations can be found in the table at Annex G.

12.43 The OTS has previously recommended that these regulations are critically reviewed with a view to their abolition if they are not shown to be necessary and justified.²¹

12.44 They are a nuisance as they unnecessarily over-complicate NICs legislation. A review should be undertaken as to:

- whether they are still needed

¹⁹ SSCBA 1992 s.15; ITTOIA 2005 Parts 1 & 2; CAA 2001, parts 1-9

²⁰ (Categorisation of Earners) Regulations - SI 1978/1689

²¹

www.gov.uk/government/uploads/system/uploads/attachment_data/file/422248/OTS_Employment_Status_report.pdf

- who is impacted if they are removed
- what the financial consequences of removing them are

12.45 While suggesting a review, we recognise that the regulations have been updated to support the employment intermediaries' rules that were introduced in April 2014.

Class 2 contributions

12.46 Class 2 contributions are payable by 'self-employed earners' which means those who are 'gainfully employed' in a capacity other than an employed one.

12.47 Class 2 NICs therefore have a wider scope than Class 4 because they include a business as opposed to a trade, profession or vocation, for example on furnished holiday lettings, which are not classed as a trade. By way of illustration, in 2011-12, 2.9 million individuals paid Class 2 NICs as opposed to 2.3 million who paid Class 4 NICs.²²

12.48 The payment of Class 2 contributions has now been aligned with the payment of self-assessment liabilities.^{23 24} Only one Class 2 contribution is due regardless of the number of self-employments.

12.49 From 6 April 2014, all entertainers engaged under a contract for services should be treated as self-employed and pay Classes 2 and 4 NICs. Any entertainers properly classed as employees (ie employed under a contract of service) must pay Class 1 NICs.

12.50 An HMRC consultation concerning the abolition of Class 2 NICs and the merger of Class 2 with Class 4 closed on 24 February 2016, and we are awaiting the outcome. We acknowledge this merger to be a simplification, and it follows an earlier OTS recommendation. This may mean that workers whose earnings fall below the Small Profits Threshold threshold might need to incur an additional cost to maintain their entitlement to state benefits.²⁵

Class 4 Contributions²⁶

12.51 Class 4 at 9% is payable on trading income which is chargeable to IT and which falls between specified lower and upper profit limits. Class 4 at 2% is payable on profits above the upper profit limit. For 2015-16 £8,060 - £42,385 are the lower and upper profit limits.

12.52 In cases of more than one self-employment, all profits are added together when considering the Class 4 liability.

12.53 Special rules apply as to what constitutes 'profits' chargeable to Class 4 NICs.

12.54 For example, trading losses are only allowed to be offset against trading income relevant to the particular trade. Unused losses can be carried forward and set against future trading profits for the purposes of calculating Class 4.

12.55 Class 4 contributions are calculated as part of the self-assessment regime and therefore payable twice yearly with balancing adjustments being made ongoing.

²² Class 2: DWP published data; Class 4: HMRC estimate

²³ Budget March 2015 following OTS recommendation

²⁴ Prior to this, payment of Class 2 is covered by SSCBA 1992, s 11; SI 2001/1004; NICA 2015, Sch.1.

²⁵ Currently the Small Profits Threshold is £5,965 (2015-16)

²⁶ SSCBA 1992, ss 15-17 and Sch 3; SI 2001/2004

12.56 A joint HM Treasury, HMRC and DWP consultation closed on 24 February 2016 examining how to abolish Class 2 and reform Class 4 to give benefit entitlement, and we await the outcome.²⁷

Table 12.B: This table illustrates the current different exemptions from Classes 2 and 4 NICs

| Class 2 NICs Exemptions | Class 4 NICs Exemptions |
|---|--|
| Persons under 16 | Persons under 16 at the beginning of the tax year who hold a certificate of exception |
| Persons over pensionable age | Persons over pensionable age at the beginning of the tax year |
| Married women pre 1977 who made elections to pay reduced rate and for whom the exemption is not revoked by dint of divorce or widowhood | Married women (married/widowed pre 1977) can elect not to pay Class 2 but must pay Class 4 (does not apply following widowhood or divorce) |
| Small earnings exemption certificate holders or those with permission from NICO pre-2015-16 | Those who are not resident for tax purposes in the UK |
| Small profits exemption from 2015-16 | Persons with profits below the lower limit |
| Someone who is incapable of working due to sickness, incapacity, maternity or employment and support allowance receipts or in legal custody or prison for a full week | Certain self-employed earners who pay Income Tax on their trading income but who are also liable to pay Class 1 NICs on that income |
| Recipients of carer's allowance or unemployability supplement | Trustees and executors who are chargeable to IT on income they receive on behalf of other people |
| Volunteer development workers who can apply to pay at a special rate share fishermen | Divers and diving supervisors working on continental shelf or in UK territorial waters |
| Foster carers not exceeding the exemption limit | Partners of LLPs can claim exemption to Class 4 if they are treated as employees and are paying Class 1 (from April 2014) Post-cessation receipts are not classed as trading profits ²⁸ Furnished holiday lettings are not classed as trading profits ²⁹ |

12.57 These differences illustrate how fragmented NICs have become. However, most of these issues are being dealt with under the current consultation: 'The abolition of Class 2 National Insurance: Introducing a benefit test into Class 4 National Insurance for the self-employed' (see footnote 13 in this Chapter) whereupon many of the above anomalies are likely to be addressed.

²⁷ 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

²⁸ CTA 2009, ss 188-200, 280-286

²⁹ ITTOIA 2005, ss 241-257, 349-356

Other issues

Employed and Self -Employed in the Same Tax Year

12.58 Someone who is both employed and self-employed in the same tax year must pay Class 1, 2 and 4 contributions, and if there is more than one employment they must pay Class 1 NICs for each employment.

12.59 The annual maximum, above which contributions will be refunded, is extremely complicated and has up to nine stages of computation attached to it - not something the person on the street would generally understand.³⁰ To obtain a refund of NICs alone, an application must be made to NICO in Long Benton but if the process involves IT and NICs an adjustment must be made through the self-assessment return. As a general point, if NICs were aggregated and annualised (see Chapter 9) there would be less of a problem with refunds under Reg. 52.³¹ It is nevertheless noted that HMRC's processes include deferment applications and further information on this is available in the guidance accompanying form CA72A.³²

Conclusion

The case for change - can employed and self-employed taxes realistically be aligned?

12.60 Taking into account the above information and representations made, it certainly seems there are a small number of areas where relatively straightforward simplification could be carried out per Table 12.C. These simplifications may not ultimately save significant administration for the payroll manager or the self-employed individual, but would be highly likely to result in a greater level of understanding by the public, as well as serving to de-clutter the existing legislation.

12.61 Complete alignment is difficult due to the different bases for taxation of employed and self-employed people. However, if NICs rates and thresholds were aligned and the NICs refunds system simplified, it may result in less confusion, more transparency and improved compliance.

12.62 If the options below were to be implemented it may also to improve the cash flow of self-employed individuals and ensure a smoother flow of funds into the exchequer.

³⁰ Further details available at NIM 24150

³¹ Social Security (Contributions) Regulations 2001, Regulations 21 and 52

³² https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/399527/CA72A_Notes_02_15.pdf

| | Current HMRC Consultation | Suggestion 1 | Suggestion 2 | Suggestion 3 | Suggestion 4 | Suggestion 5 | Suggestion 6 |
|--------------------------------------|---------------------------------|--|--------------------|----------------|--|---------------------------------|---------------------------------------|
| Deliver more equitable outcomes | N/A | Yes | Yes | Yes | Yes | Yes | Yes |
| Remove distortions | Will assist in simplifying NICs | Will place employed and self-employed taxpayers on a similar footing | Yes, in many cases | Yes | May remove the driver to avoid employer NICs | Will assist in simplifying NICs | Will assist in simplifying NICs |
| Reduce administrative costs for HMRC | Likely to be cost neutral | Likely DMB cost reductions | Yes, over time | Yes, over time | Likely over time (Compliance related) | Yes | Likely over time (compliance related) |

Potential gainers and losers

Table 12.D: This table sets out those whose level of NICs would change, and the impact on benefits entitlement

| Gainers | Losers |
|---|--|
| The self-employed would become eligible to receive welfare benefits they are not currently entitled to in return for a higher NICs contribution | The self-employed will pay a slightly higher rate of NICs up to a certain level (to be determined) |
| The NICs position for both employed and self-employed will be simpler and easier to understand | The exchequer will need to fund JSA for those self-employed individuals eligible to claim |
| The exchequer will receive slightly more NICs from the self-employed | Employed and self-employed individuals may need to pay NICs on benefits in kind received |
| The self-employed will be encouraged to pay their taxes on an ongoing basis instead of twice a year retrospectively, which will benefit both taxpayers' and the exchequer's cash flow | |

Recommendations and Potential Future Work to be undertaken

- 1 Although opinion was divided amongst our research subjects as to whether the employed and self-employed should pay the same levels of NICs, a majority did appear to favour:
 - an alignment of rates and thresholds for the employed and self-employed (given that the alignment implies the self-employed would pay higher NICs) and, in return
 - access to contributory welfare benefits by the self-employed (which is widely seen as a fairness issue and is logical given the way the UK's workforce is developing)

Our research revealed that most taxpayers are unaware that employed people pay different rates of NICs to self-employed people and on balance this does seem inequitable. The current differential could also result in the unintended consequence of an individual becoming self-employed in certain circumstances (see next item below).

Further work would need to be undertaken to assess the financial viability of this proposal and difficulty of implementation / changing legislation and we are pleased to note that a consultation on the merger of Classes 2 and 4 NICs is underway which encompasses the issue of the self-employed and contributory benefits. Responses to that consultation are currently being considered, and we await the outcome. We are, however, also conscious that certain groups would be affected by the abolition of Class 2 NICs such as loss-making businesses, low-income self-employed individuals, etc. who may have to supplement their NICs by making voluntary contributions which would cost them up to £600 per annum more than it would if they continued to pay Class 2. (This is presumably under consideration as part of the current consultation.)

- 2 The number of persons leaving employment to work for either Umbrella companies, Managed Service Companies or their own Limited company as a sole director has increased and yet it is difficult to assess whether this has been a driver to avoid employer NICs or simply a sign of the times in the modern-day world of work.
- 3 It seems sensible to re-classify any merged Classes 2 and 4 NICs to one new category of 'self-employed NICs' and remove the anachronistic 'Classes' of NICs. By so doing, three

categories of NICs could remain – ‘employed’, ‘self-employed’ and ‘voluntary’. This should not be particularly difficult to implement and any costs easy to identify.

- 4 The existing NICs refunds mechanism appears to be an overly complicated and lengthy process which costs time and money to endure on the part of the taxpayer. This system should be reviewed to assess whether it can be simplified to ensure that taxpayers can obtain refunds using a simple straightforward process in a reasonable timescale.
- 5 In line with previous OTS recommendations, removal of the categorisation of Earners Regulations to simplify NICs legislation should be considered, taking into account whether the legislation is still required at all, who will be affected, and the financial consequences of their removal on taxpayers and the exchequer.
- 6 A facility to ensure that payments on account are collected regularly from self-employed taxpayers which dovetails with the Your Tax Account should be investigated as to viability / feasibility. In a similar way to employed taxpayers who pay PAYE, self-employed individuals should also be paying regular amounts of tax on account of their final tax liability for the accounting year in question. This would ensure that funds were reaching the exchequer monthly as opposed to six-monthly and would also act as a cash-flow easement for the self-employed. In a similar way to the CS scheme, where monthly withholdings are taken from subcontractors, such a scheme could benefit both HMRC and the individual. In this way, NICs, which are assessed under self-assessment, will also be collected regularly too.

Further work needs to be undertaken to assess how such a scheme could be created and implemented, what regulation is required, what the up-front costs would be and whether it can be dovetailed with the Your Tax Account facility in due course.

- 7 Ensure that what is liable to IT for both employed and self-employed individuals is also liable to NICs so that fairness and transparency are prioritised and there is less likelihood of incentivising people to become ‘falsely’ self-employed.
- 8 Generally speaking, if it is not possible to align, then a reason should be stated as to why they cannot be aligned so that taxpayers understand what the rationale behind any misalignments is.

Discussion: legislative and administrative alignments

13

Enforcement - establishing the charge

Income Tax

13.1 It is relatively simple for HMRC to establish a tax charge. Section 29 Taxes Management Act 1970 (TMA) provides that if an officer or the Board discover:

- a) that any income which ought to have been assessed has not been assessed, or
- b) that any assessment is or has become insufficient, or
- c) that any relief which has been given is, or has become, excessive

the officer, or as the case may be, the Board, may, subject to certain taxpayer safeguards, make an assessment in the amount, or in the further amount which, in his or their opinion ought to be charged.

13.2 There are comparable provisions for establishing a tax charge where an employer or engager has failed, or appears to have failed, to pay to HMRC tax which should have been deducted under PAYE (Regulation 80 Income Tax (PAYE) Regulations 2003 SI2003/2682). Accordingly if during an employer compliance review the Officer comes to the view that tax due under PAYE has been, or may have been, underpaid, the Officer will consider making a Determination under Regulation 80. A Regulation 80 Determination protects HMRC's claim to the PAYE due/disputed.

13.3 Once the assessment or Determination has been made the person charged may appeal (s31 TMA) and, if the appeal cannot be settled by agreement, the appeal proceeds to the relevant tribunal for adjudication. Following the Tribunal's decision, legal proceedings can be taken for recovery if the person charged does not pay voluntarily (Part VI TMA).

NICs

13.4 Establishing a charge to Class 4 NICs follows the Income Tax route. Class 4 NICs are payable in the same manner as any Income Tax which is, or would be, chargeable in respect of the profits which form the basis of the assessment or self-assessment. All the provisions of the Income Tax Acts relating to collection and recovery apply to Class 4 NICs as if those contributions were Income Tax chargeable in respect of the profits of a trade profession or vocation (section 16 SSCBA 1992).

13.5 The position with regard to establishing a charge to Class 1 NICs is very different. Where an Officer comes to the view that Class 1 NICs have not been paid, and the employer or engager disputes that view, the Officer will give consideration to the need for a decision under s8 Social Security Contributions (Transfer of Functions) Act 1999. Under s8(1)(e) it is for an Officer of the Board to decide whether contributions of a particular class have been paid in respect of any period.

13.6 Where during an employer compliance review the Officer considers that a s8 Decision is necessary, he cannot himself make that Decision. HMRC's procedures require that the Decision has to be made by a nominated Decision Maker in HMRC's Employer Support Team and before the Decision is made an opinion is offered with which the employer can disagree and request a formal s8 Decision. The Decision, once made, gives the employer or engager the right to appeal against it. It does not protect HMRC's claim to the NICs due or under dispute. In order to secure that protection HMRC must lodge a Protective Claim in the appropriate Court.

Enforcement - time limits

13.7 The time limits within which various classes of legal action may be brought are provided by statute or statutory Instrument. The time limits for enforcing Income Tax and NICs debts differ considerably.

Income Tax

13.8 In England, Wales and Northern Ireland Income Tax is a crown debt. There are no time limits for the recovery of a crown debt. Both the Limitation Act 1980 and The Limitation (Northern Ireland) Order 1989 provide that there are no time limits for any proceedings by the Crown for the recovery of any tax or duty or interest on any tax or duty. We understand however that as a practical matter HMRC do not seek to recover an underpayment of tax which occurred more than 20 years ago.

13.9 In Scotland Income Tax is seen simply as a debt. Recovery is governed by the Prescription and Limitation (Scotland) Act 1973 which provides for a time limit of 20 years.

NICs

13.10 NICs constitute a civil debt. The collection of arrears of NICs is subject to the restrictions of:

- The Limitation Act (LA) for employers in England and Wales; and
- The Limitation (Northern Ireland) Order 1989 for employers in Northern Ireland

13.11 This legislation restricts the time allowed to enforce payment of a debt by civil proceedings in England, Wales and Northern Ireland to 6 years from the date on which the cause of action accrued (ie from the due date of payment). It is for this reason that it is essential for HMRC to file a Protective Claim in the Court before there is any decision by the tribunal as to the quantum of the liability (if any).

13.12 In Scotland the recovery of NICs is governed by the Prescription and Limitation (Scotland) Act 1973 which provides for a time limit of 20 years.

Tax legislation

13.13 Section 34 Taxes Management Act 1970 (TMA) provides the normal time limit for the assessment of tax which is 4 years from the end of the relevant tax period.

13.14 Section 36 TMA provides for the extension of this time limit to:

- 6 years from the end of the relevant tax period where tax has been lost due to careless behaviour; and
- 20 years from the end of the relevant tax period where the loss of tax was brought about deliberately

13.15 These time limits apply to a Regulation 80 Determination just as they apply to an assessment (Reg 80(5)).

NICs legislation

13.16 There is nothing in NICs legislation comparable with ss34 and 36 TMA. A s8 Decision must therefore be made within 6 years of the date of the liability to pay since without a Decision within that time there is no ascertained or ascertainable sum for which an action to recover can be brought (s9(1) LA 1980).

Alignment of NICs with IT

13.17 The removal of NICs from LA 1980 etc. would require:

- New time limits for the recovery of NICs. This could involve the alignment or incorporation of NICs within sections 34 and 36 TMA; and
- A new NICs structure for the collection and recovery of Class 1, 1A, 1B and 2 NICs by way of determining/assessing an amount of unpaid NICs that would confer a right of appeal while providing HMRC with a means of enforcing payment of NICs. This could involve alignment similar to Regulation 80 of the Income Tax (Pay As You Earn) Regulations 2003 (SI 2003/2682).
- The introduction of new time limits for NICs would raise further alignment issues including whether, for example, refunds of NICs should also be aligned with repayment legislation for IT. Time limits for refunds/repayments of NICs and tax, albeit different, are in line with the recovery time limits for NICs (6 years) and tax (4 years)

13.18 We recommend:

- aligning establishment of a NICs charge with the establishment of an charge, and
- aligning the time limits for recovery of a NICs debt with those for recovery of an IT debt so that there are unified time limits in each part of the UK

NICs legislation and Finance Bills – Parliamentary procedure

Introduction

13.19 It is well known that changes to NICs rules cannot generally be effected through the Finance Bill route used for general taxation. It would seem an obvious simplification to instead have changes to NICs made with all other taxes through the Finance Bill.

13.20 So we have tried to research and answer two questions:

- Why can't NICs be changed in a Finance Bill?
- Could the rules be changed so that they could be?

13.21 We set out below, in summary form, the understanding the OTS has reached on these matters following research and our consultation with the Office of Parliamentary Counsel. But our conclusions as to what it would be desirable to do, are of course our own.

13.22 In short, whether or not legislation affecting NICs can be enacted by way of a Finance Bill is governed by the rules of parliamentary procedure, relevant aspects of which are discussed below. These rules are a matter for Parliament rather than the Government.

13.23 Accordingly, it is useful to understand why Income Tax and NICs legislation is subject to different rules of parliamentary procedure, and to what extent that is the case.

13.24 In turn, this will help understanding of what it might be possible to do, if desired, to facilitate securing and maintaining alignment between the two levies.

The current position as regards NICs provisions

13.25 In general, the position is that NICs legislation is not enacted by way of Finance Bills but in separate NICs legislation.¹

13.26 So, where a change to both Income Tax and NICs legislation is desired there will generally be a need to amend those two sets of legislative provisions by way of two different Bills.

13.27 While this is - of course - feasible, it is more cumbersome than if both sets of provisions could be amended by the same Bill. It inevitably increases the risk - in practice - that the Income Tax and NICs will get or remain out of step even where that is not the policy intention. Such unintended misalignments may prove to be only short term until the other is brought back in step, or they could persist for longer if that catching up process does not have an especially high legislative priority. We have noted in our work on differences between the definitions of earnings for Income Tax and NICs (see Chapter 11) examples, including a very recent one, of such misalignments.

Finance Bill 'scope' - general position as regards NICs provisions

13.28 In terms of the rules of parliamentary procedure, Finance Bills are 'bills of aid or supply' which means they are Bills of a financial nature which (whether or not certified as Money Bills) it is established that the House of Lords cannot amend.

13.29 It is accordingly important in relation to the relationship between the two Houses of Parliament that what is included in a Finance Bill remains within the 'scope' of what is considered appropriate to such a Bill. If that were not the case, and some other 'foreign' material were annexed to it,² the amending powers of the House of Lords could be infringed.

13.30 That of course begs the question of what material is within the scope of a Finance Bill. The key to this is that contributions paid into the National Insurance Fund (NIF) are not regarded - for the purposes of parliamentary procedure - as 'charges upon the people' (ie as constituting a 'tax') or as 'subject to the rules of financial procedure' - and therefore within the scope of Finance Bills.³

13.31 The two key reasons for this view of NICs appear to be:

- the NIF is to an extent ring-fenced: the NIF can be used only to meet the costs of certain benefits, rather than to meet central government expenditure generally (notwithstanding that surplus monies in the NIF can be loaned to the consolidated fund);⁴ and
- the contributory principle: it remains the case that eligibility for at least some benefits is determined by an individual's contribution history

13.32 In addition, even if changes were made to NICs which removed these features of the situation, it is possible concern could still arise because the House of Lords has traditionally had

¹ As, for example, recently in the National Insurance Contributions Act 2015

² This is referred to as 'tacking', see House of Lords Standing Order 52

³ See page 770 of Erskine May

⁴ Additionally, the NIF can be topped up from the Consolidated fund – something that is happening at the moment

the power to amend NICs legislation; any change to that is likely to result in constitutional controversy.

Finance Bills – situations in which NICs provisions may be within ‘scope’

13.33 Provisions affecting NICs can potentially be included in a Finance Bill if they:

- concern NICs which are not paid into the NIF,⁵ or
- are ancillary to a tax provision

13.34 A provision affecting NICs would be ancillary to a tax provision if a change being made to Income Tax required a consequential change to NICs legislation for the resulting body of legislation to make sense.⁶ And a single set of provisions that relate to both tax and NICs (but are primarily about tax) can be ancillary, where they build on existing provisions that apply to both tax and NICs (at least where the provision relates to HMRC’s administrative powers or anti-avoidance). But it would not be enough simply that one desired to amend the Income Tax and NICs legislation in the same way in other circumstances, if that was not strictly necessary.

Steps which could be taken to facilitate securing and maintaining Income Tax and NICs alignment

13.35 Under the present parliamentary procedure rules it would be possible, if desired, for a NICs Bill to amend any aspects of NICs legislation so as to cross-refer to Income Tax provisions or to extend them to NICs.^{7 8}

13.36 This would mean, where relevant, that any subsequent amendments to those Income Tax provisions would automatically apply to NICs. Such amendments could be made in a Finance Bill provided they were primarily directed to the changing Income Tax position.

13.37 And, as noted above, any additional amendments to the NICs legislation concerned that were ancillary to those Income Tax changes could also be made in such a Finance Bill.

13.38 In addition, in relation to administrative provisions, there is some scope for a common approach to be secured directly through Finance Bills.⁹

13.39 It is important to recognise however, in relation to any subsequent changes to Income Tax legislation cross-referred to by NICs legislation, that it could well be necessary for the same commencement provision desired for Income Tax purposes to apply to NICs as well (as otherwise there would be a risk that any specific commencement provision for NICs would not be adjudged to be primarily directed towards changing Income Tax legislation, and thus fall outside the scope of a Finance Bill).

13.40 One particular circumstance in which this could be a concern is in relation to any provisions that, for Income Tax purposes, it was desired to bring into effect before passage of the relevant Finance Bill - by use of the Provisional Collection of Taxes Act 1968 (PCTA). At present that Act does not apply to NICs, not least because the PCTA operates by way of resolutions of the House of Commons only and legislation about NICs (which is not regarded as

⁵ For example, the increases to NICs and their allocation to the NHS provided for by NICA 2002, resulted in that Act having to be brought in on ways and means resolutions like a Finance Bill; see also page 770 of Erskine May.

⁶ This principle extended, for example, in the context of administrative provisions, to allow amendments to NICs legislation by paragraphs 84 and 85 of Schedule 36 to Finance Act 2008 (Information and inspection powers), to amend an existing single administrative regime in this regard across income tax and NICs.

⁷ As, for example, is the case in relation to Class 4 NICs (see section 15(1)(b) SSCBA 1992).

⁸ See, for example, section 10 of NICA 2014, in relation to Part 5 of Finance Act 2013 (general anti-abuse rule).

⁹ See paragraphs 84 and 85 of Schedule 36 to Finance Act 2008, discussed in footnote 5 above.

a tax for the purposes of parliamentary procedure) is generally subject to the scrutiny of the House of Lords.

13.41 Accordingly, any changes to Income Tax provision given statutory effect under the PCTA would not be able to flow through to NICs legislation until the Finance Bill is enacted (always presuming they were still regarded as within the scope of a Finance Bill).

13.42 However, there would appear to be a way of removing this potential constraint if desired, so that changes to Income Tax made under cover of a PCTA resolution could flow through to cross-referring NICs provisions. This would be for a NICs Bill to amend the PCTA to provide that where relevant Income Tax provisions are the subject of a PCTA resolution then the changes made to them by such resolutions also flow through to the relevant NICs provisions. Such a provision in a NICs Bill could be a natural and logical accompaniment to any substantive changes inserting cross-references to Income Tax legislation into NICs legislation to which the PCTA could be relevant.

Conclusion

13.43 The reason that NICs cannot generally be changed in Finance Bills rests in Parliamentary procedure rather than law, but it is clear it would be difficult to change this.

13.44 The main reason for seeking a change would be to ensure that the two levies keep in step.

13.45 On the basis that the scope of Finance Bills is unlikely to change, we recommend changing NICs legislation in such a way that future Income Tax changes automatically apply to NICs as well.

Constraints on alignment – an example concerning the internationally mobile

13.46 The proposals in this report cover many types of misalignment. We do not underestimate the difficulties in achieving greater simplification and we acknowledge the effort that has already been made to produce a NICs regime which works for modern employment patterns. The example below shows that sometimes a practical solution to a particular misalignment may not easily be found, and may require more than one attempt to achieve a workable result.

Internationally mobile employees and Employment Related Securities – new NICs disregard

13.47 We heard many complaints from employers and advisers about the new rules for the NICs treatment of employment related securities ('ERS' - for example, share options) awarded to internationally mobile employees which came into effect on 6 April 2015. Before then all or no ERS income was subject to NICs – depending on the insurability of the individual when the award vested. Following OTS recommendations, IT rules on the apportionment of ERS awards were amended and subsequently the NICs rules were amended to follow the IT rules as closely as possible within the constraints of the international social security framework. The NICs legislation assesses the amount to be apportioned using the rules set out in ITEPA, but the actual rules on apportionment diverge from the IT rules. The NICs legislation has a disregard¹⁰ that removes from earnings the amount relating to periods when the individual was not subject to UK social security.

13.48 We learned that employers do not appreciate the complexity that arises from having to do different apportionment calculations for IT and NICs. It was described as a 'payroll headache'.

¹⁰ Paragraph 18 Part IX Schedule 3 SI 2001/1004

Employers are now in the position that they may have to track an employee's insurability for up to ten years from the grant of an award. A further issue is the increased possibility of double charges arising as it is still possible that another country may claim social security is due on a portion that is subject to UK NICs. There is no way to resolve double charges other than to contact the HMRC International Caseworker team.

13.49 So here is a case where the international complexities of social security prevent a full alignment for IT and NICs and employers feel the half way position has not helped them.

A Terms of reference

Alignment of Income Tax and National Insurance

Introduction

The Office of Tax Simplification (OTS) has agreed with the government to undertake a study into the closer alignment of Income Tax and National Insurance contributions. The aim is to build on the OTS's earlier work and recommendations in this area, to understand the different stages of improving the alignment of the taxes. The OTS will publish a final report ahead of Budget 2016. It may publish an interim report and/or calls for evidence during its work.

Terms of reference

The main aim of the project is to explore more fully the steps that would need to be taken to achieve closer alignment of Income Tax and National Insurance contributions, and the costs, benefits and impacts of each of those steps. The report will consider the evidence already available, including previous OTS work, and undertake further research with stakeholders and taxpayers. The OTS will consider in particular:

1. The case for change, including the distortions, burdens and costs associated with the current system.
2. The changes that could be introduced to bring the two systems closer together in relation to the taxation of earned income (for employers and employees) and the self-employed.
3. The costs, benefits and impacts of each step.
4. All forms of NICs charge, including employers' NICs
5. How any changes would fit with wider government policy/objectives, including:
 - The system of determining entitlement to contributory benefits;
 - Exchequer costs
 - Burdens for business

The review will consider the base of the systems but will not consider the extension of NICs to non-employment income (such as property, dividends and pensions). In carrying out its work and framing its recommendations, the OTS should have regard to:

- The effect on taxpayer and business understanding of the system
- The likely effect on compliance burdens
- The impact on any distortions to current taxpayer behaviour caused by the current system
- Avoidance risks
- The principles and design of HMRC's Making Tax Easier reforms, including digital tax accounts, integrated reporting and payment
- HMRC operational impacts

- Likely revenue implications, both in terms of exchequer impact and the impact on different types of taxpayers
- Administrative costs for government (including the administration of the contributory benefit system)
- Fairness and consistency of treatment of taxpayers

Resources

The OTS will take on staff to undertake the fieldwork for this project and will also need appropriate expertise to assist with work around impacts of potential changes.

The OTS may, in association with HMRC, commission external research to assist with any aspects of the work.

Background: Income Tax and NICs and previous OTS work The UK imposes two levies on income: Income Tax and national insurance contributions (NICs). Although superficially both tax the same thing, in practice there are wide differences, for example:

- Income Tax taxes (in principle) all income; NICs are levied on employment earnings and self-employment profits, and not on other forms of income such as savings, pensions or investments.
- The basis of calculation for employment income are different between Income Tax (on an annual basis across all income sources) and NICs (on an earnings basis per employment and per pay period for employed earners).
- The legal definitions of earnings are different for Income Tax and employee NICs, with a number of items relating to employment, including benefits in kind and expenses, being treated differently between the two codes.
- Although both Income Tax and NICs are collected under PAYE, Income Tax is collected on a cumulative basis; NICs on a pay period basis.
- NICs continue to have a contributory link, although some commentators have suggested that this is much weaker than in the past.
- The (annual) starting points for the two levies, once aligned, are now considerably different.
- The self-employed pay NICs at a lower rate than employees and under the contributory system, have slightly reduced benefit entitlement, although the planned abolition of Class 2 NICs would mean that the self-employed will pay a single class of NICs like employees.

Employee and employer NICs are largely aligned. Cash and cash-like elements (such as shares and other readily convertible assets) of both are largely aligned and collected through PAYE on a pay period basis. Other non-cash elements (benefits in kind) are charged to employer NICs only and collected at the end of the year in a separate payment, although from 2016 some non-cash elements may be collected voluntarily through the payroll in line with previous OTS recommendations.

In the OTS Small Business Review, differences in the rules and procedures between the Income Tax and NICs systems were found to be the second highest source of complexity for small businesses. The report identified that maintaining two separate systems led to a number of anomalies, helping to distort business behaviour. The OTS recommended bringing the two

systems close together and, importantly, set out a number of stages that could be taken to implement this while stopping short of a full merger. Our point was that each of the stages would yield simplification dividends.¹

Following the OTS Small Business Review², in 2011 the government set up a number of stakeholder groups and commissioned external research into attitudes of small employers, and a paper was published summarising the results. It was decided to wait for progress on other changes to the tax system that employers were implementing (for example on Real Time Information and the Scottish Rate of Income Tax) before consulting further on aligning the operation of Income Tax and NIC.

The OTS's subsequent UK Competitiveness Review and Employment Status report both returned to the issue of IT/NICs alignment. Both reports reiterated the difficulties caused by the differing systems; closer alignment was seen as a way of improving competitiveness and as the main indirect way of 'solving' employment status problems. The impact of the employers' NICs was seen a major issue in both cases.

¹ The integration of Class 2 into Class 4 was one of the steps we recommended.

² Integration of the two systems has been suggested in a number of independent reports, including the IFS: Integrating income tax and national insurance: an interim report, and the Mirrlees Report chapter 5: Tax by Design.

B Consultative Committee

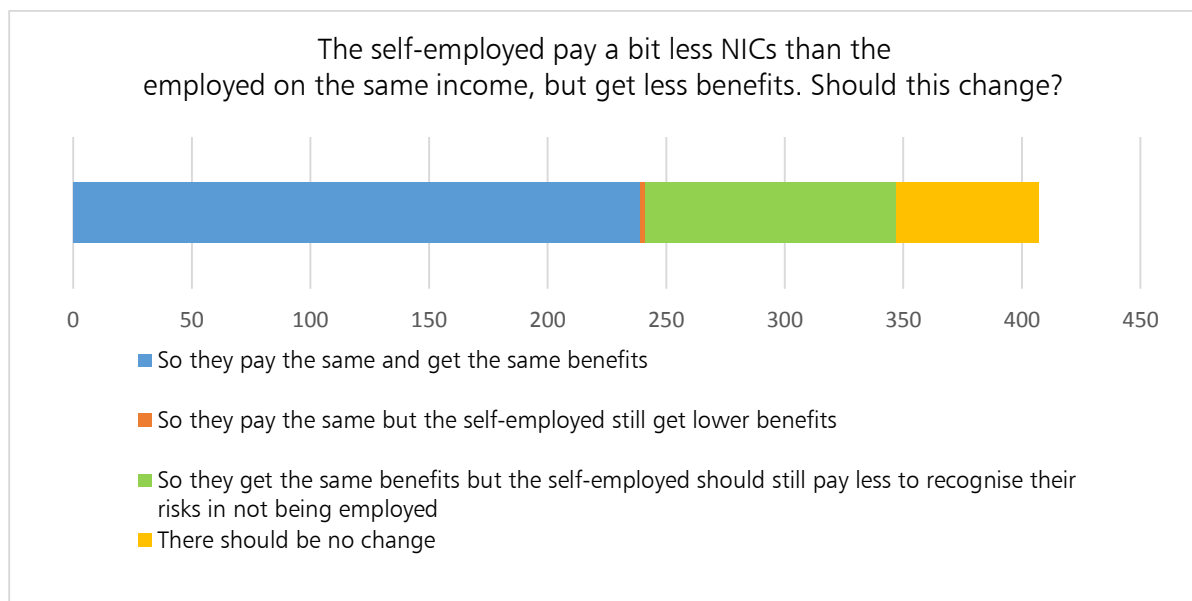
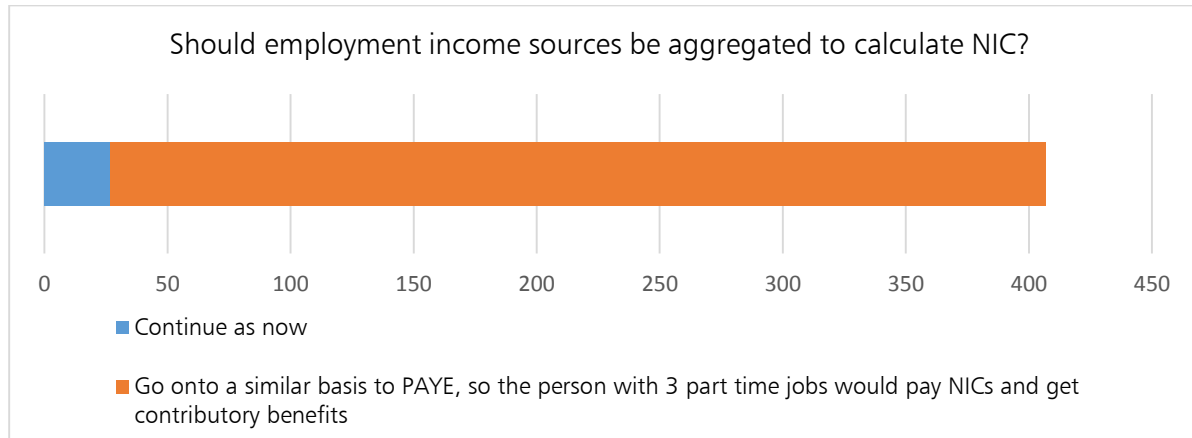
| | |
|------------------|---|
| Stuart Adam | Institute for Fiscal Studies |
| David Bateman | Department of Work and Pensions |
| Colin Ben-Nathan | KPMG |
| Charlie Dwyer | HM Revenue & Customs |
| Stephen Herring | Institute of Directors |
| Belinda Johnson | Work Lab Ltd |
| Simon Manclark | HM Revenue & Customs |
| Stephen Relf | CCH and Applause Accountancy Services Limited |
| Jenny Rowland | HM Treasury |
| Paul Tucker | Smith & Williamson |
| Robin Williamson | Low Incomes Tax Reform Group (LITRG) |

C Online survey results

The OTS ran two online surveys from 18 November 2015 to 8 January 2016, one for individuals and one for tax practitioners and payroll professionals. A selection of responses is given below.

Survey of employed and self-employed individuals.

608 people viewed the survey, and most questions had about 400 responses.

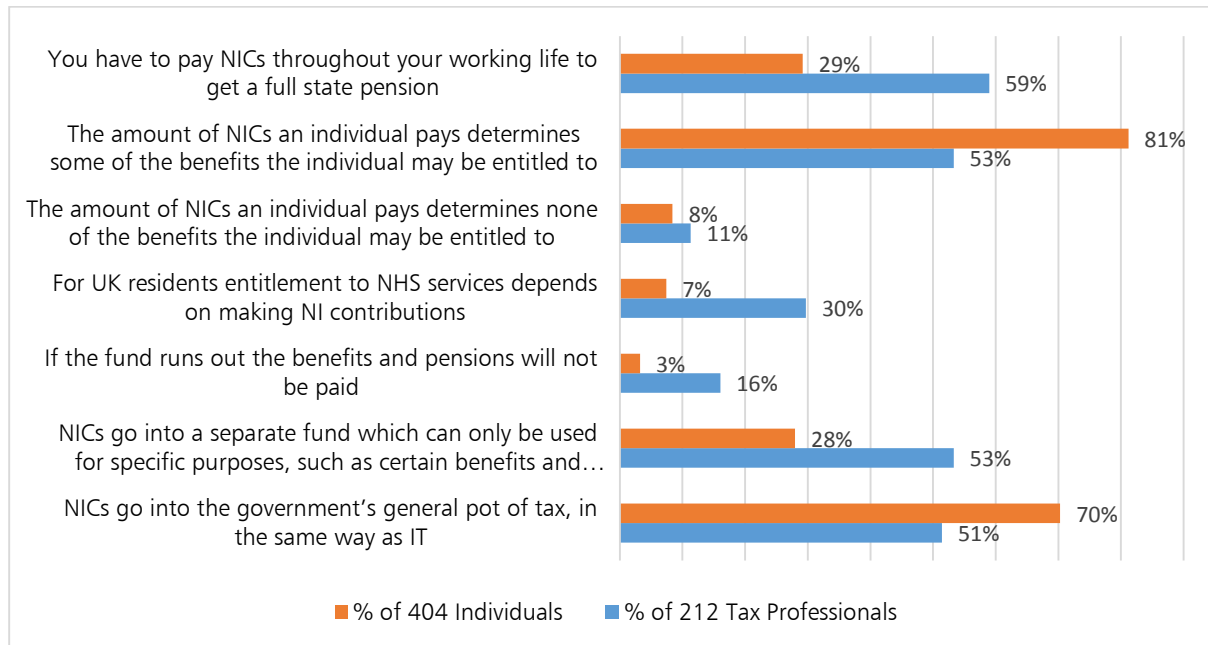


Respondents were asked for their comments on the simplification of Income Tax and NICs. The vast majority of comments suggested that NIC should be merged into Income Tax, to create one tax at a higher rate. This was thought to drive transparency, fairness and simplicity for taxpayers. The next highest category suggested aligning NICs closer to Income Tax PAYE including the alignment of thresholds, rates and definitions to reduce complexity. Some respondents suggested a simpler system for employer NICs, and removing distortions created by rental income, benefits, dividends, IR35 and pensions. Finally there was an overall desire for greater transparency and fairness across the computation, collection and contributory nature of NICs.

In the next question, we tried to gauge understanding about NICs:

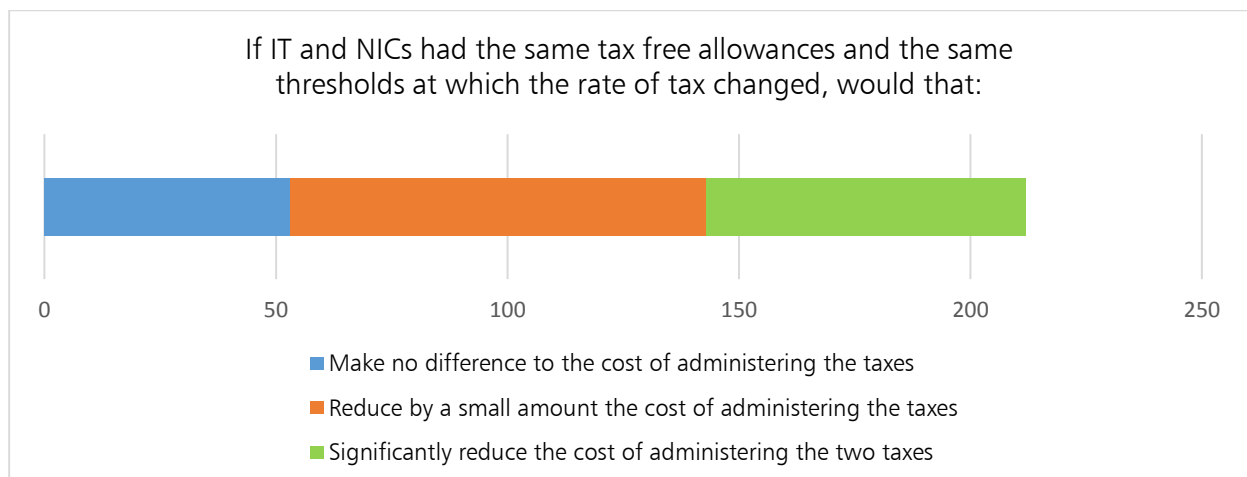
NICs are sometimes regarded as having a different purpose to income tax:

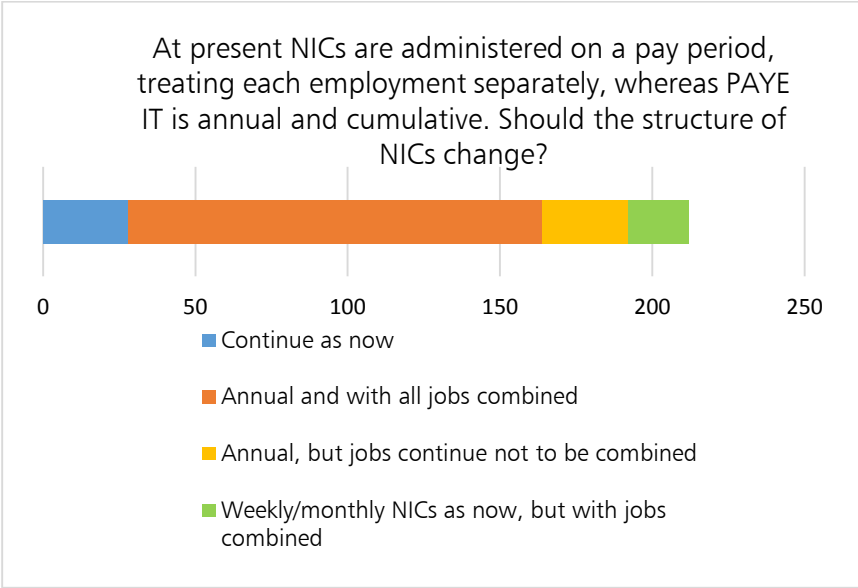
Individuals: Please tick any of the following which you think applies
 Tax Professionals: What do you think that the average employee / person believes about NICs?



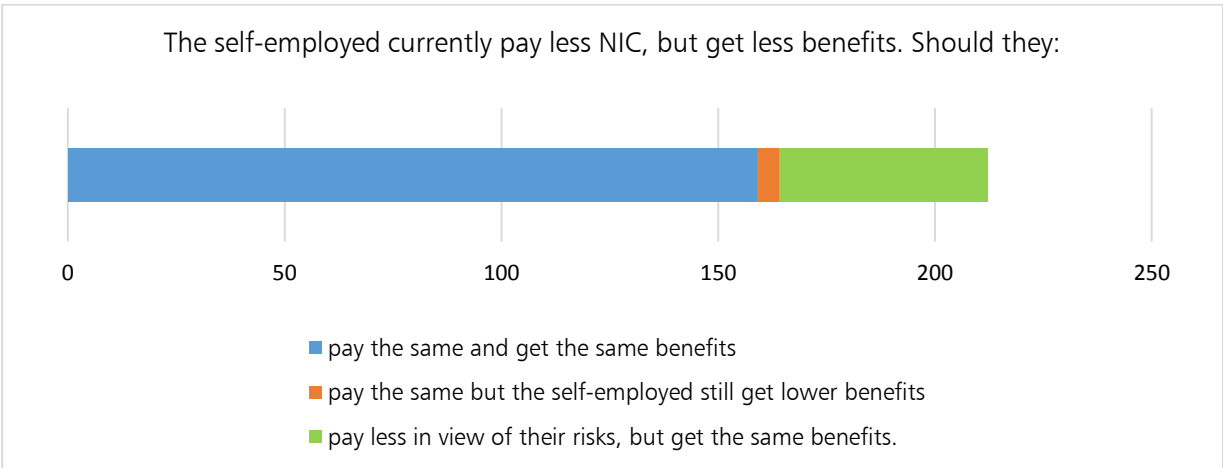
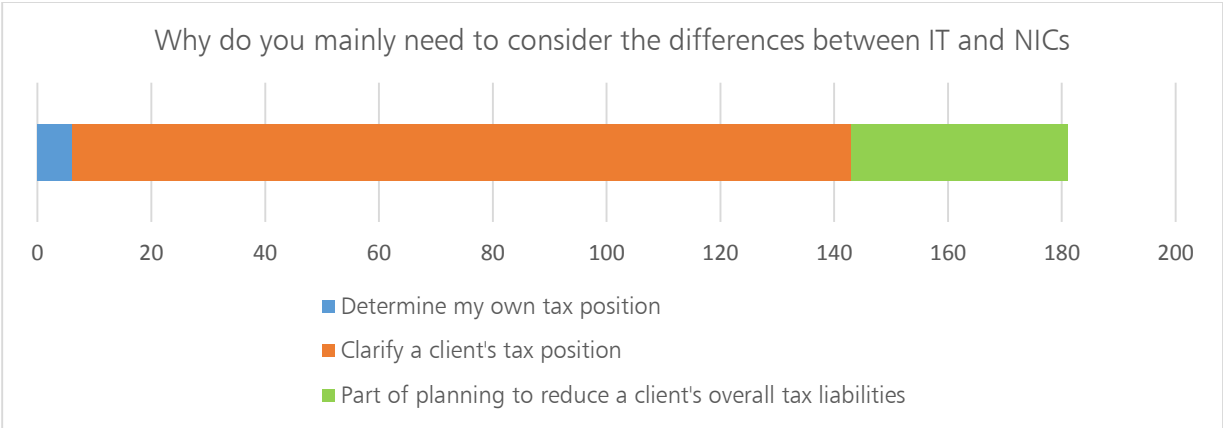
Survey of tax practitioners and payroll professionals

Most questions had about 200 responses, including 71 tax advisers and 141 payroll professionals, Of the tax professionals, 70% advise monthly or less frequently, and 96% said the frequency of advice remains the same or is increasing.

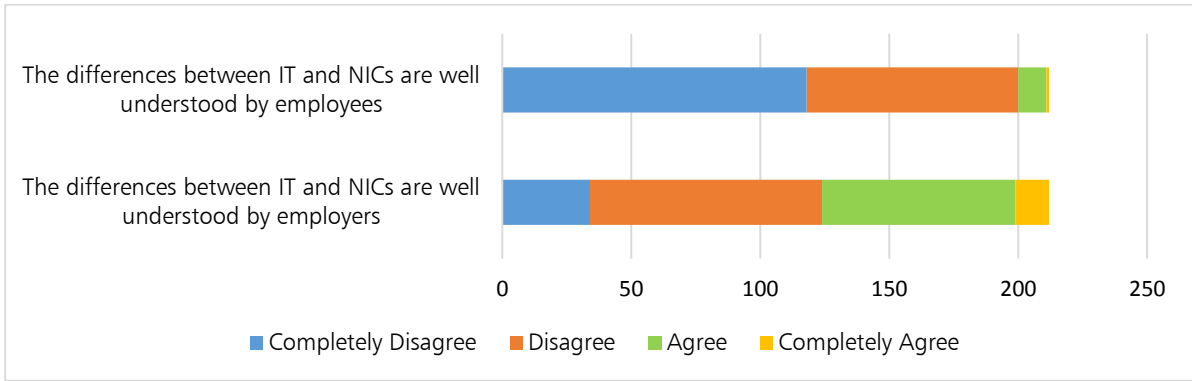




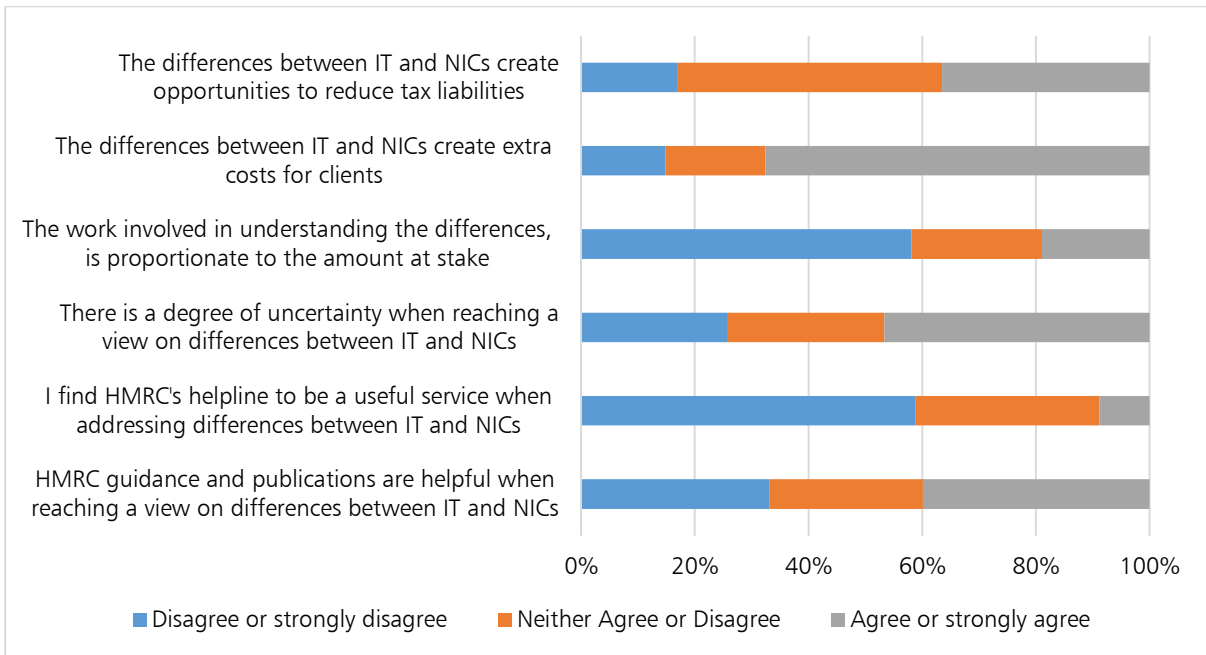
The majority of additional freehand comments supported the combination of NICs and Income Tax, with support for a payroll based charge, as a means of greater transparency and simplification.



Both individuals and tax professionals felt that there should be greater parity between the employed and self-employed – in principle, they should pay the same and get the same benefits.

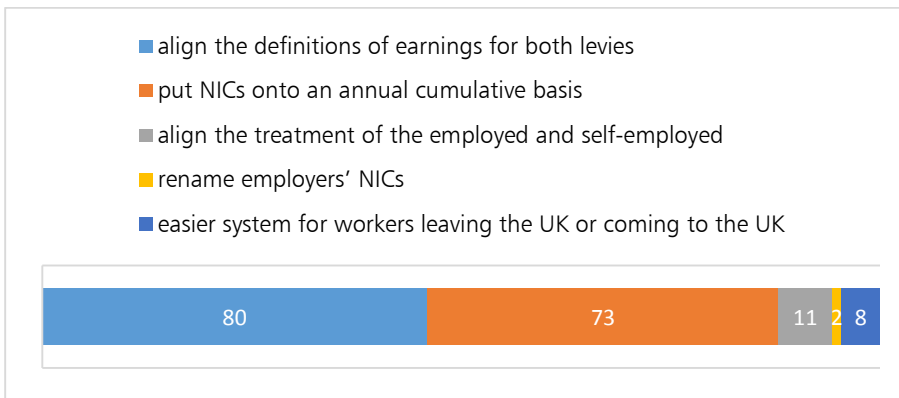


The 212 tax professionals had these views about the differences between IT and NICs:



There is some agreement that the differences between IT and NICs create planning opportunities, but certainly drive costs and create uncertainties. This is disproportionate to the amounts involved.

If you could make one change, 212 tax professionals said.....



D 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. We list them below and apologise to any that we have inadvertently omitted.

| | |
|--|--|
| Association of Accounting Technicians | Grant Thornton LLP |
| Barclays Bank Plc | Greater Manchester Business Growth Hub |
| BDO LLP | Institute for Fiscal Studies |
| BECTU | Institute of Chartered Accountants in England & Wales |
| Bishop Fleming | Institute of Chartered Accountants of Scotland |
| Brewin Dolphin Plc | Institute of Directors |
| British Chamber of Commerce | KPMG LLP |
| British Hospitality Association | Low Incomes Tax Reform Group (LITRG) |
| Centre for Policy Studies | Martin Gunson |
| Champion Accountants | National Enterprise Network |
| Chartered Institute of Payroll Professionals | PricewaterhouseCoopers LLP |
| Chartered Institute of Taxation | Princercroft Willis |
| CIOT Employment Taxes Forum | Resolution Foundation |
| Citizens Advice Bureau | RTI Taskforce forum |
| Confederation of British Industry | Tax Payers Alliance |
| Crowe Clark Whitehill | TaxAid |
| Deloitte LLP | Tesco Plc |
| Employment Taxes in Industry Forum | TUC |
| Equity | UK Chamber of Shipping |
| Ernst & Young LLP | UK200 Group |
| FMP Global | |
| Forum of Private Business | |
| Freelancer & Contractor Services Association | We also met or received submissions from a number of individuals |
| Goodman Jones | |

E International comparisons

E.1 We looked at the social security arrangements in a number of countries and in our meetings we asked for suggestions of countries which have well integrated tax and social security arrangements which might be a model for the UK.

E.2 In summary, no model stands out for its simplicity, indeed some commented that internationally the UK has an easier system to understand in that there is only one social security levy. In contrast some countries disaggregate contributions into many separate charges (which along with other difficulties in administration, gives rise to very complex payslips).

Key differences and comments

E.3 We have summarised each social security system below, providing an overview, details of contributors, payments and rates and benefits available via the social security system (or similar). Generally, as with the UK, both the employer and employee pay a social security tax. In most countries coverage includes the self-employed; sometimes the contribution made by the individual reflects both an 'employee' and 'employer' element.

E.4 However, what is clear from our review is that how the systems operate and ultimately what they provide differs greatly, therefore when comparing these to the UK we do not have a 'like for like' comparison.

E.5 Furthermore it is difficult to comment on what works well or, conversely, where challenges are faced in respect of the system operation for each country without delving deeper into each system individually, as we have done for the UK. As such, we have given thought to where we see benefits/potential weaknesses and how these might be adopted/avoided by way of reforms to the UK system.

E.6 We begin with the Irish social security system. There are similarities with the UK in that a percentage of wages are withheld via PAYE and paid into a social security fund. However, one key difference is that the social security charge applies not only to employment income, but also income from property, profits and gains. The UK is unlikely to extend the scope of NICs to such income.

E.7 The Nordic countries we reviewed (Norway, Sweden, Finland and Denmark) have extremely comprehensive systems, which are admired globally. However, we were made aware that even these systems are not without some issues. For instance, the current systems are reliant on strong labour markets therefore questions may arise around sustainability. Additionally, we note that where services are not provided by the State directly (ie some services in Denmark) and, instead, via municipalities, regions or private providers via outsourcing, tension can be created where there is inconsistency between the promises of welfare made and the reality of what it would cost the individual municipalities to deliver these. Finally, although the social security systems in the Nordic countries is extensive, combined tax and social security rates are significantly higher than in the UK, to facilitate this.

E.8 The French social security system is similar to the UK in that contributions are withheld from wages and paid to a fund. However this fund has historically run at a deficit, which then requires a transfer of funds from general taxation. Additionally, the contributions due are broken down into separate elements, potentially making the calculations and documentation of these on payslips difficult for individuals to understand. Separating the elements in this way is unlikely to be adopted by the UK, given the primary aim is to make the system simpler.

E.9 New Zealand is again considered as having an extremely effective welfare system, viewed as being well developed and supported by a generally stable economy. As the text below summarises, the system is very different to the UK ie there are no social security contributions and, instead, state benefits are funded by general taxation. Any consideration by the UK of such a system would have a number of political and social considerations and may be difficult to advance.

E.10 The Canadian system appears to have elements of complexity that that UK system does not, such as the differing contribution and benefit entitlement depending on residency.

E.11 Finally, the USA social security system does not offer the range of benefits that are available in the UK and those that are available appear to be subject to very stringent conditions. It is noted that many social programs are limited in duration whereby short term rather than permanent institutions are created, as a result of available funding.

Summary of overseas arrangements

Table E.1: The arrangements for social security in a number of countries are outlined very briefly below:

| Country | Republic of Ireland |
|--------------------------|---|
| Social Security overview | <p>Pay Related Social Security (PRSI) – paid by employees, employers and self-employed as a percentage of wages after pension contributions, withheld via PAYE and paid into a Social Security Fund. Applies, as with Income Tax, to income from property, profits and gains.</p> <p>Universal Social Charge (USC)– second Income Tax</p> <p>Non-contributory payments financed by general taxation</p> |
| Contributions payable by | <p>Employed contributor – employee and employer contributions.</p> <p>Self-employed and company directors – no employer contribution, calculate PRSI in the year-end Income Tax return.</p> <p>Voluntary contribution – voluntary for those aged between 16 - 66 and no longer classed as employed or self-employed contributor. Can help maintain pension entitlement (does not provide other cover).</p> |
| Payments and Rates | <p>PRSI payable depends on earnings and the classes under which the individual is insured (11 different classes and a number of subclasses).</p> <p>Employed – depends on age, earnings and type of work. Liable on all unearned income eg rental income for those who self-assess. Majority – Class A - PRSI of 4% on earnings (above minimum limit, currently €352 per week) with no upper limit. From 2016 there will be a new credit for people earning between €352.01 and €425 per week. This will be tapered and will be a maximum of €12.</p> <p>Employer – Class A rate of 10.75% (reduced to 8.5% for low-paid) on all employment income excluding share based remuneration.</p> <p>Self-employed – Class S rate 4% on all earnings or €500, whichever is greater. No employer contribution.</p> <p>Voluntary – can opt to pay if conditions met.</p> |

| | |
|--------------------------|--|
| | <p>USC rate depends on age. Between 1% - 8% depending on the level of income.</p> <p>Self-employed are subject to a 3% surcharge if their income is over €100,000.</p> |
| Social security benefits | <p>Contributory benefits – entitlement based on PRSI contribution. Each payment earns the employee a ‘credit’/‘contribution’ used to establish entitlements to non-means tested welfare such as Jobseekers benefit and state pension (contributory). Health contribution used to fund health services although not linked to entitlement to treatment.</p> <p>Non-contributory – means tested, not linked to PRSI contributions ie healthcare, medical cards.</p> <p>Universal payments – benefits paid regardless of means or contributions ie child benefit.</p> |
| Country | Norway |
| Social Security overview | <p>Social security system covers individuals - all persons who are either resident or working as employees or on Norwegian Continental Shelf.</p> <p>Scheme is financed by individual and employer contributions in addition to state grants.</p> |
| Contributions payable by | Employees, employers and self-employed |
| Payments and Rates | <p>Employee – 8.2% of personal income (includes salaries, benefits, pensions, social security benefits). Allowance before payment due but no cap. Income exceeding certain limits subject to a surtax.</p> <p>Employer – 14.1% (potentially lower regionally) on total gross salary (and taxable benefits).</p> <p>Self-employed – 11.4% pensionable income (income from fisheries 8.2%). Allowance before payment due but no cap. ‘Split income’ – tax business profits exceeding the interest on the capital invested</p> |
| Social security benefits | <p>Old age, survivors, disability pensions.</p> <p>Disablement benefits</p> <p>Work assessment allowance</p> <p>Occupational injury benefits</p> <p>Single parents benefits</p> <p>Cash payments for sickness, maternity, adoption, unemployment</p> <p>Medical benefits</p> |

| Country | Sweden |
|--------------------------|--|
| Social Security overview | <p>Covers everyone working or living in Sweden (intention to reside for more than 1 year) although may qualify for different benefits depending on whether you work or not.</p> <p>Residence based (regardless of whether working or not – healthcare, child allowance, minimum pension).</p> <p>Earnings related (for employees such as sickness compensation, earnings based-state pension).</p> <p>Notional defined contribution type pension.</p> <p>Pay-as-you-go.</p> <p>No option to remain covered by the Swedish Social Security system on a voluntary basis.</p> |
| Contributions payable by | <p>Paid by employers for the employed. All compensation for employment is subject to social security, including cash and taxable benefits (subject to specific exceptions).</p> |
| Payments and Rates | <p>Employee – 7% of annual taxable income to a maximum limit. Contributions withheld by employer. Receive tax reduction for same amount so result is no extra costs for social security payments.</p> <p>Employer – compulsory 31.42% of payroll, no cap. Reduced for those over 65.</p> <p>Self-employed – 28.97% of net income. Rates can be decreased if accept a longer waiting period for sickness insurance. Reduced rates depending on age.</p> |
| Social security benefits | <p>Health insurance</p> <p>Accidents at work and occupational diseases</p> <p>Invalidity benefit</p> <p>Old-age and survivors pensions</p> <p>Unemployment insurance</p> <p>Family benefits</p> <p>Parental insurance</p> <p>Note – entitlement depends on work record, whether the particular benefit is means tested etc.</p> |
| Country | Finland |
| Social Security overview | <p>Social security system covers individuals living and working in Finland and can apply in three circumstances:</p> <ul style="list-style-type: none"> • Wage loss: unemployment, retirement etc. • Social burdens |

- No earned income

Two schemes:

- Residence based for all (regardless of whether they work) – provided by Social Insurance Institution (KELA). Benefit entitlement decided by reference to the length of residence.
- Employment related – provided by private insurance companies and the Finnish Centre for Pensions (ETK)

Contributions payable by Employees, employers and self-employed

Payments and Rates
 Employee – payable on uncapped gross salary. Totalling approximately 9%, covering healthcare, pension insurance, unemployment insurance etc. Withheld by employer.
 Employer – contribution totalling approximately 23%, set percentage for each benefit.
 Self-employed – must insure personal pension rights, so pay a contribution of 23.6% (rate differs depending on age). Advised to take voluntary accident insurance (as not covered by statutory accident insurance).

Social security benefits
 Residence based benefits:
 National pensions (see below)
 Family benefits – maternity, paternity, child maintenance etc.
 Student financial aid (parents income dependant).
 Sickness (treatment, sickness allowance, disability pension, rehabilitation, occupational health services, special care allowance)
 Disability benefits and rehabilitation
 Housing benefits (earnings related)
 Survivors benefits
 Employment related benefits:
 Earnings related unemployment coverage (paid by KELA. unemployment allowance – basic or earnings related - and labour market subsidy),
 Employment pension (earnings related)
 Group-life and accident insurance

| | |
|--------------------------|--|
| Country | Denmark |
| Social Security overview | Based on residence and financed through taxes. |

| | |
|--------------------------|---|
| | <p>Covers all residents in Denmark (employees, self-employed, civil servants, non-active persons, pensioners, students and refugees).</p> <p>Compulsory for residents.</p> <p>Low Social security contributions – treated as a tax since 1 January 2011.</p> |
| Contributions payable by | Employees, employers and self-employed. |
| Payments and Rates | <p>Employees - pay flat rate monthly contribution (ATP contribution - DKK 94.65) before taxes which goes towards statutory supplementary pension scheme. Many also pay non-statutory contributions to occupational pension schemes and to voluntary unemployment funds. Many collective labour agreements govern pensions.</p> <p>No separate contributions required for health insurance coverage.</p> <p>Employers - pay flat rate monthly contribution per employee of 189.35DKK towards pension. Also required to pay contributions to labour market funds (8%) and occupational private accident insurance. If employee entitled to sick pay – covered by employer for first 4 weeks.</p> <p>Self-employed - can participate in the statutory supplementary pension scheme on a voluntary basis, paying an annual contribution of 270 DKK.</p> |
| Social security benefits | <p>Healthcare</p> <p>Sickness benefit</p> <p>Accident at work/occupational diseases</p> <p>Unemployment benefit- managed by unemployment funds; employees and self-employed must sign up voluntarily.</p> <p>Family benefits</p> <p>Maternity/paternity benefits</p> <p>Pension (65 or 67 years old) – Statutory pension financed via tax payments. Based on number of years meeting entitlement earnings limits – for full pension, 40 years required. Statutory supplementary pension – based on contributions.</p> <p>Early retirement – also based on contributions, like public pension</p> <p>Death grants/survivors benefits.</p> |
| Country | Germany |
| Social Security overview | <p>Statutory social security system can apply in three circumstances:</p> <ul style="list-style-type: none"> Wage loss ie unemployment, retirement etc. Payment for dependents (income supplements) No professional income outside claimants control (basic income) |

| | |
|--------------------------|---|
| | Compulsory social security covers pension insurance, unemployment insurance, health insurance and nursing insurance for disability or old age. |
| Contributions payable by | Those subject to compulsory social insurance ie employers, employees, unemployed etc. Direct payers ie self-employed. Not subject to the compulsory scheme but can join voluntarily. |
| Payments and Rates | Compulsory insured –Based on percentage of employees salary, subject to monthly maximum amount. Equal parts paid by employees and employer (other than certain regional differences where employer rate is less). Differing rates for West and East Germany. Premium payable by employee for disability and old age insurance if childless. In total, employers share of the contributions amounts to approximately 21% of the employee’s gross wage. Direct payer – self-employed making voluntary payments must pay both the employee and employer elements. |
| Social security benefits | Medical treatment Sickness benefit (after 6 weeks of absence due to illness) Pregnancy benefits Retirement - pension depends on contributions ('equivalence principle' - unlike other benefits). Unemployment Accidents at work (funded by employer only) Family benefits (financed by taxes rather than contributions) |
| Notes | For those who are not entitled to compulsory coverage, can obtain voluntary coverage (subject to certain conditions) ie those who went abroad to work. No voluntary unemployment insurance. |
| Country | France |
| Social Security overview | Social security system can apply in three circumstances: Wage loss ie unemployment etc. Social burdens eg childcare, sickness No earned income outside individuals control |
| Contributions payable by | Employees, employers and self-employed. |
| Payments and Rates | Salaried persons – deducted from gross pay. Rates differ depending on risks. For this reason, information on payslip is complex. 18-23% of gross remuneration, on average. |

| | |
|--------------------------|---|
| | <p>Employer – 40-45% of gross salary, on average.</p> <p>Self-employed – depends on the nature of the self-employment. Certain contributions are capped.</p> |
| Social security benefits | Salaried persons – healthcare, sickness benefits (including disability), accidents at work, occupational diseases, family benefits, maternity and paternity benefits, unemployment, basic and supplementary retirement pensions, death grant, |
| Notes | Voluntary social security fund exists for those who work outside France, subject to certain conditions. |
| Country | Australia |
| Social Security overview | <p>No social security contributions.</p> <p>Individuals required to pay Medicare tax (public health insurance).</p> <p>Compulsory superannuation contribution deducted from wages.</p> |
| Contributions payable by | <p>Medicare – payable by employed and resident in Australia.</p> <p>Superannuation – employers required to make minimum contributions to superannuation fund on behalf of their employees.</p> <p>Self-employed - not required to make personal contributions but may do so if they choose.</p> |
| Payments and Rates | <p>Employee - Medicare – rate of 2% of taxable income, above threshold. Low Income Taxpayers exempt. Certain people exempt ie non-resident. Surcharge payable above higher income level. Levy collected with Income Tax.</p> <p>Employer - Superannuation – 9.25% of employee earnings. Withheld from employees pay and are deductible to the employees. Contributions can be made directly by the individual. Surcharge if income above set limit.</p> |
| Social security benefits | <p>Resident based benefits:</p> <p>Pension (no employee contributions mandatory but encouraged via tax incentives)</p> <p>Sickness and maternity (medical benefits funded by Medicare)</p> <p>Work injury benefit (funded by insurance premiums)</p> <p>Unemployment benefits (funded by general revenue)</p> <p>Family allowances (funded by general revenue)</p> |
| Country | New Zealand |
| Social Security overview | <p>No social security contributions. State benefits are funded by general tax revenue. However the following charges apply:</p> <p>Work account levy – covers work-related injuries.</p> |

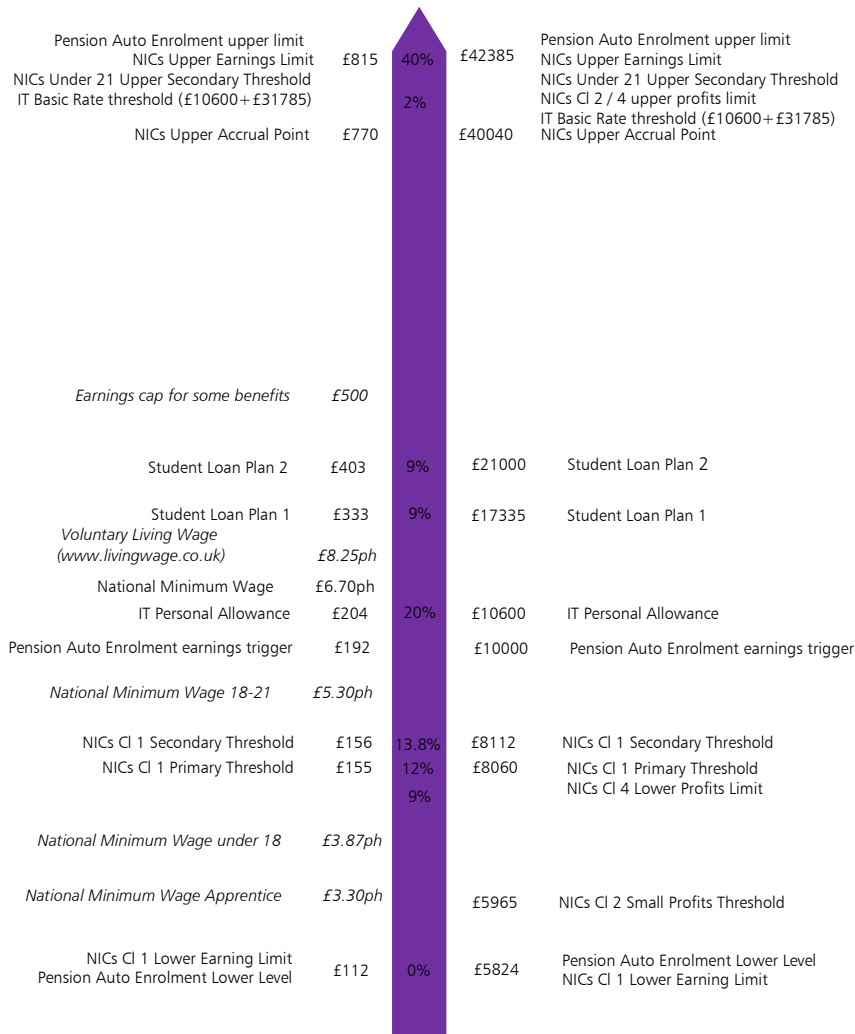
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|--------------------------|--|
| | <p>Earners account levy covers medical, rehabilitation and weekly compensation costs for a work injury.</p> <p>Kiwisaver – superannuation fund, voluntary work-based savings scheme.</p> <p>Retirement scheme contribution tax.</p> |
| Contributions payable by | <p>Work account levy payable by employers, self-employed workers and private domestic workers.</p> <p>Earners account imposed on all employees, self-employed and private domestic workers.</p> <p>Health and safety levy employers, self-employed workers and shareholder employees.</p> |
| Payments and Rates | <p>Work account levy – depends on industry, based on employee payroll.</p> <p>Earners account levy - 1.26%. Deducted from salary or wage income.</p> <p>Health and safety levy – 8 cents per NZD 100 of earnings.</p> <p>Kiwisaver – individual can choose what rate to contribute (3%, 4% or 8% of gross pay) or opt out altogether. Employer contributes 3% of gross pay.</p> <p>Retirement scheme contribution tax – rate specific to individual.</p> |
| Social security benefits | <p>Funded by general tax revenue:</p> <p>Pension (flat rate) and old age benefits</p> <p>Sickness and maternity</p> <p>Unemployment</p> <p>Family allowance</p> <p>Work injury, funded by Work levy</p> |
| Country | Canada |
| Social Security overview | <p>Social security scheme comprises 3 main elements:</p> <p><i>Canadian Pension Plan (CPP) – contributory, earnings-related social insurance programme; or</i> <i>Quebec Pension Plan (QPP) – as per CPP</i></p> |
| Contributions payable by | <p>All over 18 who are employed or self-employed (subject to a few exceptions).</p> <p>QPP – individuals working in Quebec.</p> |
| Payments and Rates | <p>Contributions split between employer (4.95%) and employee (4.95%) Based on remuneration and taxable benefits ('pensionable earnings'). Annual exemption below which no contributions due. Annual maximum contribution limit.</p> |

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| | <p>Self-employed must pay both parts. 9.9% pensionable earnings.</p> <p>QPP - increased rate (5.1% employer and employee).</p> |
| Social security benefits | <p>Retirement pension (if worked in Canada, made at least one valid contribution and at least 60 years old)</p> <p>Disability pension</p> <p>Survivors benefits (if contributions for three years)</p> |
| Notes | <p>CPP/QPP contributions not deductible for federal or provincial Income Tax purposes but creditable against taxes paid. Employer matching contribution not taxable on individual.</p> <p>Voluntary CPP/QPP for those not eligible permitted in certain circumstances.</p> <p><i>Old Age Security (OAS) - pension</i></p> <p>May be entitled even if still working or have never worked or living outside Canada.</p> |
| Contributions payable by | Not contribution-based. Financed by Government of Canada general tax revenues. |
| Payments and Rates | N/A |
| Social security benefits | <p>Benefit provided:</p> <p>Monthly payment to those over pension age (65 or older). Determined by age, legal status and number of years living in Canada.</p> <p><i>Employment Insurance (EI) – temporary financial assistance</i></p> <p>In Quebec, EI supplemented with Quebec Parental Insurance Plan.</p> |
| Contributions payable by | As for CPP/QPP |
| Payments and Rates | <p>Percentage of earnings payable by employee (1.88%) and employer (2.632%), subject to annual maximum contribution.</p> <p>Employer collects employee part and pays combined amount over.</p> <p>Reduced rates for Quebec EI.</p> |
| Social security benefits | <p>Temporary financial assistance including:</p> <ul style="list-style-type: none"> • regular benefits, • unemployment benefit, • maternity and parental benefits, • sickness benefits, • compassionate care benefits • fishing benefits |

| Country | USA |
|--------------------------|--|
| Social Security overview | <p>Social security and Medicare imposed via a tax on employees and employers.</p> <p>Self-employed pay both parts.</p> <p>Social security taxes paid are not allocated for the payer but rather paid to those currently collecting benefits.</p> <p>Individuals who are not otherwise required to contribute cannot make voluntary contributions.</p> |
| Contributions payable by | <p>Employees - FICA (Federal Insurance Contributions Act)</p> <p>Self-employed - SE tax</p> |
| Payments and Rates | <p>Old age, survivors and disability:</p> <p>Employee – 6.2%, up to maximum limit.</p> <p>Employers – 6.2% of payroll, up to maximum limit</p> <p>Self-employed – 12.4% up to maximum limit.</p> <p>Medicare:</p> <p>Employee – 1.45%, no maximum. Additional 0.9% when compensation exceeds certain limits.</p> <p>Employer – 1.45%. No maximum</p> <p>Self-employed – 2.9%, no maximum earnings. Additional 0.9% potentially due dependant on income.</p> |
| Social security benefits | <p>Retirement (must have at least 40 quarters of coverage to qualify, subject to certain exceptions)</p> <p>Disability (if had at least one quarter of coverage for each year since age 21 and must have 20 quarters of coverage in the 10-year period before disability began)</p> <p>Survivors (provided deceased was pensioner and had a quarter of coverage for each year from 21).</p> <p>Hospital insurance – Medicare (to those aged 65 and older who are eligible for pension, plus certain others ie on disability benefit for more than 2 years)</p> |

F Thresholds, rates and bands

Chart F.1: This chart is intended to illustrate the complexity of differing rate bands for employers, employees and self-employed



G Comprehensive list of misalignments and differences

[Legislative framework](#)

[General scope](#)

[Earnings from employment](#)

[Assessment and collection](#)

[Receipts with different treatments](#)

[Different treatment for deductions from earnings when payment made by employee](#)

[Treatment of trading losses](#)

[Individual's residence status/ overseas matters](#)

[Special classes of worker](#)

[Self-employed](#)

[Voluntary tax payments](#)

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|---|---------------|---|-------------------------------------|
| LEGISLATIVE FRAMEWORK | | | | |
| 1. Duration | A temporary tax, requiring renewal annually through the Finance Act | s. 4 ITA 2007 | Permanent, although thresholds reviewed annually before the beginning of the tax year | s. 1 SSCBA 1992 s. 141 SSAA 1992 |
| 2. Destination of tax receipts | Consolidated Fund ('CF'), administered by HMT Treasury | | National Insurance Fund (NIF), managed by HMRC, net of proportion directed to Consolidated Fund to part fund NHS | s. 161(1) SSAA 1992 |
| 3. Use of associated Fund | CF finances the expenditure of government departments as approved annually or permanently by Parliament | | NIF finances specified benefits to individuals, generally linked to the individual's record of contributions to the NIF. Potential for supplementary transfer from CF means benefits will be funded regardless of NIF's current year income | |
| GENERAL SCOPE | | | | |
| 4. UK pensions | Yes | Part 9 ITEPA | No | |
| 5. Foreign Income | Yes | Part 8 ITTOIA | No | |
| 6. Dividends | Yes | s. 383 ITTOIA | No, but IR35 may be used to recategorise income | |
| 7. Interest etc. | Yes | s. 369 ITTOIA | No | |
| 8. Other Annual profits or gains (former Sch D Case VI income) | Yes | s. 687 ITTOIA | No | |

| | Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|--|---|--------------------|---|----------------------|
| 9. | Non-employer linked trust income | Yes | s. 683 ITTOIA | No | |
| 10. | Commercial Holiday Letting | Yes | Part 3 ITTOIA | Not Class 4, but Class 2 liability may arise | s.122(1) SSCBA |
| 11. | Rents and other income from land | Yes | Part 3 ITTOIA | Not Class 4, but Class 2 liability may arise | s. 122(1) SSCBA |
| 12. | Foreign Self-employment income of Non-Resident Multi-State EU worker working temporarily in UK, where self-employment carried on wholly abroad | No | | Class 2 may arise | s. 1(6) SSCBA |
| EARNINGS FROM EMPLOYMENT | | | | | |
| 13. | Definition of earnings | Statutory definition of earnings - not aligned with definition of 'earnings' for NICs | s. 62 ITEPA | Definition for NICs purposes is broader than for Income Tax | s. 3 SSCBA |
| 14. | Who is liable to bear the tax? | Employee only | s. 13 ITEPA | Earner (Primary); Employer or Employer (Secondary) | Host s. 6 SSCBA 1992 |
| ASSESSMENT AND COLLECTION OF IT and NICs IN RESPECT OF EARNINGS FROM EMPLOYMENT | | | | | |
| 15. | Identification of individual taxpayer | Unique taxpayer reference ('UTR'), used for all taxes on individuals other than NICs | | National insurance number (NINO) | |

| | Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|-----|-------------------------------------|--|---|--|--|
| 16. | Means of annual reconciliation | Self-Assessment | s. 9 TMA | No general end of year reconciliation | |
| 17. | Basis of calculation | Income of the year, cumulative and totalled | s. 8 TMA | Income from each individual employment in the earnings period | SSCR 2001 SI 2001/1004 Regs 2-9 |
| 18. | Payments on account? | Payments on account built into the system | Part 11 ITEPA PAYE Regs SI 2003/2682 | Facility for payments on account available only to Directors and others on cumulative assessment | SSCR SI 2001/1004 Reg 8(6) (directors) |
| 19. | PAYE Settlement Agreement due dates | 19 October (nb all other PAYE due dates have the same potential extension as NICs) | Reg 109 SI 2003/2682 | 19 October or if by approved electronic method 22 October | Sch 4 Para 13 SI 2001/1004 |
| 20. | Threshold for Payment 2015/2016 | Personal Allowance £10,600, with variations for age, marital status and high earnings | | Class 1 Primary Threshold (monthly paid) £8,064; Secondary Threshold (monthly paid) £8,112 | |
| 21. | Rates | 3 rates of tax (20%, 40% and 45%) applied as income increases regardless of the individual's status | s. 6 ITA | Class 1: 6 rates determined by the individual's status (Category Letter). Special rules for under 16; under 21; apprentices; married women; pensioners | SSSCR SI 2001/1004 Reg 12(2) |
| 22. | Upper Limit | No Upper Limit. The higher the income the higher the marginal rate. Withdrawal of PA means a 60% marginal rate between £100,000 and £121,200 | | No Upper Limit, but where earnings exceed £3,532 per month (£43,384 p.a.) the rate drops to 2%. As NICs is assessed on a per job/per pay period basis multiple jobs carry the risk of overpayment. Multiple job holders can apply for a Certificate of Deferment where a person has more than one job and earnings in one job are expected to exceed £43,384 in the year, but this is not generally appreciated by taxpayers | |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--------------------------------|--|--------------------------------|---|------------------------------------|
| 23. Clawback/ Payment in error | If emoluments are overpaid there is an established route to secure refund of the tax deducted under PAYE | s. 11 ITEPA 2003 | It is very time-consuming to secure refund of any NICs, especially where an earner has multiple Class 1 employments and deferment has not been sought or where Class 4 NICs have been paid in excess of the Annual Maximum. No equivalent in NICs law to 'negative earnings' in s11 ITEPA | Reg 52 to 57 SI 2001/1004 |
| 24. Underpayments of tax | Recovery from employer unless underdeduction results from an error in good faith. If underdeduction due to such an error, recovery from employee HMRC can also recover from the employee where the employee received income knowing that the employer wilfully failed to deduct tax | SI 2003/2682 Regs 72 and 80 | Recovery from Secondary Contributor- usually the employer. If underdeduction due to an error in good faith, employer can recover from employee subject to monetary and time limits. If full recovery not possible by end of the tax year following the underdeduction, employer bears the cost of what remains unrecovered. Primary Contributions recoverable from earner (employee) only in deferment cases or where the Secondary Contributor is outside the jurisdiction | SSCR SI 2001/1004 Sch 4 Para 16 |
| 25. Time limits for recovery | No time limit for the recovery of an unpaid tax debt | | Recovery of an unpaid NICs debt in England and Wales subject to the 6 year time limit imposed by the Limitation Act 1980 There is a 20 year time limit in Scotland | |
| 26. Establishing the charge | Assessment | s. 29 TMA 1970 | Assessment by Notice of decision and enforcement, or County Court claim, required within 6 years to protect NICs debt from becoming unenforceable | s. 8 SS(TF)A 1999 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|--|------------------------------------|---|--|
| 27. Other allowances | IT has a multitude of reliefs and allowances which may reduce tax liabilities on earned income, e.g. blind persons allowance; share loss relief etc. | Part 2 Chpt 3 and Part 3 ITA | No allowances other than primary, secondary thresholds | |
| RECEIPTS WITH DIFFERENT TREATMENTS | | | | |
| 28. Termination payment | Specific employment income for IT purposes, if not earnings. £30,000 exemption | s. 62 ITEPA or Chpt 3 Part 6 ITEPA | For NICs earnings if from the employment contract otherwise no equivalent to specific income provision so wholly exempt | s. 3 SSCBA 1992 (For redundancy payments there is a specific disregard, otherwise NIC legislation is silent on termination payments Part X Sch 3 para 6 SI2001/1004) |
| 29. Tips and Gratuities | Yes | s.62 ITEPA | Only if received and shared out by employer | SSCR SI 2001/1004 Sch 3 Part X para 5 |
| 30. Third party payments made by employer | Not payrolled | s. 62 ITEPA | Payrolled | SSCR SI 2001/1004 Sch 3 para 2(1)(b) |
| 31. Earnings received after death | Yes | s.13 ITEPA | No | |
| 32. Bonus paid by company owned by an Employee Ownership Trust | Exempt up to £3,600 per annum | s. 290 and Sch 37 FA 2014 | No corresponding disregard for NICs purposes | |
| 33. Non- cash vouchers | Not payrolled, P11D | s. 87 ITEPA | Payrolled | |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|---------------------------------------|---|--|---|
| 34. Benefits | Most are taxable, not payrolled, P11D | Part 3 ITEPA 2003 – benefits etc. treated as earnings | No Class 1 NICs liability on most benefits in kind – Class 1A is payable instead, so liability only falls on employer (unlike for other earnings) | s. 10 SSCBA 1992 – Items that are general earnings under ITEPA but are not subject to Class 1 are subject to Class 1A |
| 35. Benefits – mixed use i.e. asset partly used in a way which would qualify for a business use or travel deduction for IT. | IT charge on private element | s. 336 ITEPA 2003 | NICs on all benefit | (No equivalent to s.336 ITEPA) |
| 36. PAYE not recovered from employee | Not payrolled | s. 222 ITEPA | Payrolled | SI 2001/1004 Reg 22(4) |
| 37. Loan released or written off | Not payrolled | s. 188 ITEPA | Payrolled | s. 3 SSCBA |
| DIFFERENT TREATMENTS FOR DEDUCTION FROM EARNINGS WHEN PAYMENT MADE BY EMPLOYEE | | | | |
| 38. Pension contributions | Deductible | Sch 36 FA 2004 | Not deductible | |
| 39. Necessary employment expenses incurred by employee, not reimbursed by employer | Deductible on SA return or via coding | s. 336 ITEPA onwards | Not deductible Only reimbursed expenses and expenses paid for by the employer are covered by disregard. Also definitions in IT and NICs legislation are different, but in practice make little difference | Part VIII Sch 3 SI 2001/1004 |
| 40. Expenses paid out of foreign earnings | Deductible | s. 353 ITEPA | Not deductible | |

| | Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|---|---|-----------------------------------|---|---------------------------------------|
| 41. | Interest on qualifying loans | Deductible | Part 8 ITA | Not deductible | |
| 42. | GAYE/ Gift Aid | If you give to charity through payroll you get tax relief but not NICs relief. Gift Aid payments are tax relieved at higher and additional rates | s. 713 ITEPA/ Part 8 Chpt 2 ITA | Not deductible | |
| 43. | Subscriptions/professional fees | Deductible | Bodies approved under s.344 ITEPA | Not deductible | |
| 44. | AMAPS (Approved mileage allowance payments) | These reduce to from 45ppm to 25ppm for IT after 10,000 miles. Where the employer does not reimburse business mileage at the full AMAPS rates the employee can claim tax relief on the difference | s. 229 onwards ITEPA 2003 | There is no reduction in rates for NIC. Employees cannot claim a NICs refund if the employer does not pay relevant motoring expenses. Relief from NICs cannot be claimed where the employer reimburses at less than the approved mileage rate | Reg 22A 2001/1004 |
| TREATMENT OF TRADING LOSSES | | | | | |
| 45. | TREATMENT OF TRADING LOSSES | Trading losses may be relieved against employment income | s. 64 ITA | Relief not available against Class 1 NICs. The only relief for trading losses is against Class 4 NICs. Any loss not so relieved is carried forward. Thus where a trading loss is set against earnings from employment the carry forward figures for IT and NICs will be different | SSCBA Sch 2 para 3(1)(a) |
| INDIVIDUAL'S RESIDENCE STATUS/OVERSEAS MATTERS | | | | | |
| 46. | Who is chargeable? | Chargeable if the employee is Resident or Not Resident | ss. 15 and 27 ITEPA | Chargeable if the earner is present, Ordinarily Resident or Resident | SSCBA s.1(6) and SI 1004/2001 Reg 145 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|---|---|---|----------------------------|
| 47. Definition of residence | Statutory Residence Test | s. 218 and Sch 45 FA 2013 | No definition in NI legislation of presence, residence or ordinary residence | |
| 48. Liability of outbound employees | On leaving the UK on secondment for full-time employment abroad individual ceases to be liable except in respect of UK- source income | FA 2013 Sch 45 Part 3 | On leaving the UK on secondment for full-time employment abroad individual continues to be liable for 52 weeks after departure, subject to any Bi-Lateral Agreements or EU Directives provided specified conditions are met. EU Reg on posted workers extends beyond 52 week period | SI 1004/2001 Reg 146(1)(2) |
| 49. Liability of inbound employees | On coming to the UK on secondment for full-time employment individual is liable from the date of arrival in the UK | FA 2013 Sch 45 Part 3 | On coming to the UK on secondment for full-time employment individual is not liable until 52 weeks have elapsed from the date of arrival, subject to any Bi-Lateral Agreements or EU Directives | SI 1004/2001 Reg 145(2) |
| 50. Short Term Business Visitors – employees of foreign branch | No exemption from Income Tax for STBV employee of a foreign branch of a UK employer | There is no distinction between the UK employer and the foreign branch. Therefore Article 15(2)(b) of the OECD Model Convention is not satisfied. | Exemption from NICs available to STBV employee of a foreign branch of a UK employer | SI 1004/2001 Reg 145(2) |
| SPECIAL CLASSES OF WORKER | | | | |
| 51. Under 16 | No age limits | | No Class 1 | SSCBA 1992 s. 6(1) |

| | Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|-----|------------------------|---|--|---|--|
| 52. | 16 – 20 | No age limits | | Class 1 primary No Class 1 secondary payable from 6 April 2015 up to Upper Secondary Threshold (UST). Class 1 secondary paid thereafter at 13.8% [exemption from Class 4 must be specifically requested.] | SSCBA 1992 s. 9A, as inserted by NICA 2014 s. 9 |
| 53. | Apprentice under 25 | No age limits | | Class 1 primary No Class 1 secondary payable from 6 April 2016 up to apprentice upper secondary threshold (AUST). Class 1 secondary paid thereafter at 13.8% | SSCBA 1992 s. 9B, as inserted by NICA 2014 s. 14 |
| 54. | Over state pension age | No age limits | | No Class 1 primary. Class 1 secondary paid regardless of age | SSCBA 1992 s. 6(3) |
| 55. | Directors | Taxed as earnings from office or employment | ss. 4 and 5 ITEPA | For NICs calculation purposes - standard annual earnings period method <u>or</u> alternative method (NICs each pay period then reconciliation at the end of the year) | SSCR 2001, Reg 8 |
| 56. | Mariners | Taxed as earnings from employment | Seafarer's Earnings Deduction available – s. 372 ITEPA | UK resident or domiciled - treated as 'employed earnings employment' for Class 1 NICs purposes subject to certain conditions (whether or not liable to UK Income Tax). Unless superseded by reciprocal agreement Only apply if engaged under a contract of service. Must be gainfully employed in Great Britain – treated as this if British Ship or contract entered into in UK and person paying earnings has a place of business in Great Britain | SSCR 2001 Regs 115 – 119 Definitions of mariners – Reg 115 – master or member of the crew of any ship or vessel or on board any ship or vessel in some other capacity. Reg 121 SSCR 2001 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|------------------------------|----------------------|-------------|---|---|
| 57. Share fishermen | Taxed as a trader | | <p>From 6 April 2014 - defines who the secondary contributor should be. Special rates of employers Class 1 subject to certain conditions</p> <p>Any person employed in the fishing industry otherwise than under a contract of service as a master or member of the crew of any UK fishing vessel (as defined) manned by more than one person and remunerated by way of a share of the profits <u>or</u> any person who by reason of age or infirmity becomes an on shore fisherman (remuneration as above). Liable to pay an increased rate of Class 2 contribution (£3.45 per week from 6 April 2015) in order that they may acquire a contribution record which will entitle them to contribution-based jobseeker's allowance</p> | <p>No equivalent of s. 372 ITEPA in NICs legislation</p> <p>SSCR 2001, SI 2001/1004</p> <p>Reg 125(c)</p> |
| 58. Married women and widows | No special rules | | <p>Before 11 May 1977 women who were married or widowed had the right to elect not to participate in the NICs scheme, and as such to pay Class 1 contributions at a reduced rate (5.85% vs 12%) and escaped payment of Class 2 contributions altogether. The idea behind this opt-out was that the woman would receive a state pension based on her husband's contributions only</p> <p>Reduced liability election withdrawn when marriage terminated, widow is no longer in receipt of bereavement benefit</p> | SSCR 2001 Regs 126-139 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|-------------------------------------|--------------------|---|---|
| 59. Partners | | | <p>or no contributions are paid for at least 2 consecutive years</p> <p>In April 2012, HMRC advised that they consider sleeping partners and inactive limited partners as 'gainfully employed' (previously the reverse view)</p> <p>Salaried partners may now be classed as employees for NICs purposes subject to certain conditions</p> <p>Where a partner is an employee then the partnership becomes the employer and liable for secondary Class 1 NICs</p> | |
| 60. Foster parents | | ITTOIA ss. 803-828 | <p>Payments made to foster payments above a certain limit are exempt from tax. Assumed also exempt from Class 2 and 4 NICs but no statutory basis (although accepted by HMRC in practice).</p> | |
| 61. Continental shelf (mainly Oil-rig workers, divers and diving supervisors) | Taxable as earnings from employment | s. 41 ITEPA | <p>Anyone who is employed (employed or self-employed) in connection with the exploitation of resources or the exploration of the sea bed and subsoil in any 'designated area' is deemed for contribution purposes as if those areas are in Great Britain, where the employment is in connection with any activity mentioned in Petroleum Act 1998, s 11(2)</p> <p>From 6 April 2014 as a result of NICA 2014 and an amendment to the SSCR</p> | <p>SSCBA 1992 s. 120</p> <p>Continental Shelf Act 1964, s. 1(7)</p> |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|----------------------|-------------|---|--|
| | | | 2001, SI 2001/1004 that was introduced to ensure that non-UK employers of UKCS workers paid employer NICs in the UK, and to stop avoidance achieved in the past by routing UKCS employments deliberately via an offshore intermediary | |
| 62. Divers and diving supervisors whose duties consist wholly or mainly of seabed diving activities | Taxable as a trader | s.15 ITTOIA | Any diver or diving supervisor ('diver') who is employed and performs the duties in the UK or in UK waters is treated as self-employed for Income Tax purposes. For all other purposes (including NICs) they are treated as employed. Therefore the divers are subject to Class 1 NICs, and this exemption ensures that they are not subjected to Class 4 as well | SSCR SI 2001/1004 Reg 92 |
| 63. International air transport workers | | | UK resident or domiciled aircrew who are employed under a contract of service - treated as 'employed earnings employment' for Class 1 NICs purposes subject to certain conditions. Unless superseded by reciprocal agreement | SSCR SI 2001/1004 Reg 111 |
| 64. Volunteer development workers | No | | Young people (ordinarily resident in UK) who participate in development projects in a recognised developing country. Those who are not treated as employees because they are not resident in the UK are treated as self-employed for contribution purposes for services rendered outside Great Britain. Special rate of Class 2 payable (higher, as per fishermen) to acquire/maintain contribution records on basis of which he will be entitled to contribution based | SSC Reg 2001, SI 2001/1004 Regs 149 and 150. |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|----------------------------------|-------------|--|---|
| 65. Statutory categorisation of earners | | | <p>jobseeker's allowance and, in certain cases, industrial injuries benefit</p> <p>In order to enable difficult/inconvenient categorisation questions to be resolved, regulations may be made to provide:</p> <ul style="list-style-type: none"> • For employment of any prescribed description to be disregarded in relation to the liability for NICs which would otherwise arise from employment of that description; and • For a person in employment of any prescribed description to be treated as falling within a category of earner <i>other than that in which he would otherwise fall</i> <p>Where these regulations do apply it can mean that National Insurance treatment differs from the Income Tax and/or PAYE treatment</p> | <p>Social Security (Categorisation of Earners) Regs 1978, SI 1978/1689</p> <p>SSCBA 1992, s. 2(2)</p> |
| Employment disregards for NICs | | | | |
| 66. Certain domestic employment by close relatives | Taxable if a contract of service | | Disregard for NIC (unless the employment is for the purpose of any trade or business being carried out in that private dwelling-house by the employer) | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 7 in Part III of Sch 1 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|--|----------------------------------|--------------|---|---|
| 67. Certain employment of a person by his or her spouse/civil partner other than in a business role | Taxable if a contract of service | | Disregard for NICs if employed by spouse other than for the purposes of the spouse's employment, whether or not it is under a contract of service | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 8 in Part III of Sch 1 |
| 68. Extraordinary employment as a self-employed earner | Taxable if a contract of service | | Any self-employment or deemed self-employment where the earner is not ordinarily so employed i.e. someone who is an employed earner and undertakes a one-off job for which he is paid a small fee. Such a person would not be regarded as 'ordinarily self-employed' and would be disregarded | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 9 in Part III of Sch 1 |
| 69. Employment on or after 6 April 1978 as a returning officer etc. | Yes | s. 62 ITEPA | Fees received by returning officers and their staffs for duties performed at parliamentary and local elections are disregarded for NICs purposes. Subject to tax as employment income | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 2 and 10 in Part III of Sch 1 |
| 70. Certain employments in a visiting force | No | s. 304 ITEPA | Employment as a member of the naval, military or air forces of specific countries, unless the individual is ordinarily resident in the UK, disregarded for NICs purposes. | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 12 Part III of Sch 1 |
| Categorisation as employed for NICs | | | | |
| Earnings in respect of employments of the following kinds are treated as falling within the category of <i>employed earner</i> therefore Class 1 NICs due. | | | | |
| 71. Office cleaners | | | Generally treated as employees for NICs (normal status rules for tax). Secondary contributor the agency/third party who | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) Reg 2 and para 1 of Part I of |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|----------------------|-------------|---|--|
| 72. Cleaner of telephone apparatus and associated fixtures | | | supplies the cleaner or person with whom the cleaner contracts to do the work As per Office Cleaners | Sch 1 and Reg 5 and para 1 of Sch 3 As per Office Cleaners |
| 73. Certain agency workers | | | From 6 April 2014, extensive amendments resulting in persons supplied by agencies are deemed to be employed earners and the associated agencies to be their employers where certain conditions are met | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 2 in Part I of Sch 1 |
| 74. Employment of a person for business purposes by his or her spouse or civil partner. | | | Generally treated as an employee. Unless if employed by spouse and reside in the same house. If this is the case, disregard | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 8 in Part III of Sch 1 |
| 75. Certain employments as ministers of religion | | | Ministers of non-established churches, including the Roman Catholic Church, would ordinarily be classed as self-employed. However treated as employed earner for NICs unless his remuneration in respect of his employment does not consist wholly or mainly of stipend or salary | SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 5 in Part I of Sch 1 |
| 76. Certain lecturers, teachers or instructors (until 6 April 2012) | | | Prior to 6 April 2012 teachers treated as employed earners for NICs purposes, provided certain conditions were met | SS (Categorisation of Earners) (Amendment) Regs 2010 (SI 2012/816, Reg 4) |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---|----------------------|-------------|---|---|
| 77. Certain actors, musicians and other performers (until 5 April 2014) | | | <p>Prior to 6 April 2014 majority of entertainers treated as employed earners for NICs purposes</p> <p>From 6 April 2014 regulations concerning entertainers were repealed. Entertainers not engaged under a contract of service are treated as self-employed for NICs purposes</p> | SS (Categorisation of Earners) (Amendment) Regs 2003 (SI 2003 No. 736) |
| Other | | | | |
| 78. Examiners, moderators, etc. of certain examining bodies | | | Generally treated as self-employed earners for NICs purposes, even where gainfully employed | <p>SS (Categorisation of Earners) Regs 1978 (SI 1978 No.1689) para 6 in Part II of Sch 1</p> <p>HMRC Employment Status Manual, paras ESM4150 to ESM4153</p> |
| 79. Volunteer development workers | | | See above. Categorised as self-employed earners, provided they do not derive from their employment earnings in respect of which Class 1 NICs payable | |
| SELF-EMPLOYED | | | | |
| Class 2 | | | | |
| 80. Fixed rate tax on self-employed | No equivalent in IT | n/a | Class 2 begins in the week of the individual's 16th birthday | |
| Class 4 | | | | |
| 81. Supplementary liability on self-employed trading income. | No equivalent in IT | n/a | Class 4 tax on profits, subject to exception from Class 4 liability: | 2001/1004 Reg 97 |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|-------------------------------|---|--|---|-------------|
| | | | <ul style="list-style-type: none"> • persons over pensionable age and persons not resident in UK. • Divers and diving supervisors • persons under the age of 16 • Sleeping partners and limited partners not exempt from 6 April 13 / 6 April 15 respectively. • persons treated as employed | |
| 82. Profit base | Adjusted trading profit less capital allowances | ITTOIA Parts 1 & 2 and CAA 2001 Parts 1 to 9 | Adjusted trading profit persons treated as self-employed for tax and employed for NICs | s. 15 SSCBA |
| VOLUNTARY TAX PAYMENTS | | | | |
| | | | | |
| | | | | |
| 83. Voluntary | No equivalent in IT | | Contributions do not attract benefit entitlement (and therefore cannot be paid) in respect of the year in which state retirement age is reached | |

| Issue | Current IT treatment | Legislation | Current NICs treatment | Legislation |
|---------------------|----------------------|-------------|---|-------------|
| Class 3A 84. | No equivalent in IT | | Contributions were introduced in October 2015 to allow state pensioners of any age as at 5 April 2016 to top up their state pension | |

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