

LOW INCOMES TAX REFORM GROUP

HM Revenue & Customs – Including Benefits in Kind and Expense Payments in the Payroll: A Fresh Approach RESPONSE TO CONSULTATIVE DOCUMENT

1. Executive Summary

- 1.1. We understand and support the rationale behind suggesting that benefits in kind and expense payments are included in the payroll, given the administrative savings that may result for employers. Thus we believe that the current paper is a worthwhile study but we do feel that more work needs to be done regarding the practical issues the proposed changes will lead to and the impact on low-income taxpayers.
- 1.2. One particular area of concern is the proposed removal of the £8,500 earnings threshold, which will create an additional tax burden on some of the poorest members of society; a constituency which is already about to suffer an extra tax burden through removal of the 10% income tax band unless this can be counteracted through the tax credits system. But we acknowledge the practical problems this threshold creates for employers and, for those reasons, the logic of its removal. To resolve the opposing advantage for employers against the downside for low-income employees in removing the threshold, we suggest that more research is done to identify those taxpayers who are likely to be affected and for HMRC to thereto give consideration to alternative remedies.
- 1.3. This response calls for:
 - A full review of the potential impact on tax credits and welfare benefits claimants before a decision is taken on payrolling (para 3.2.3).
 - An undertaking to be given by HMRC that the unrepresented employee will be provided with clearer guidance under these new proposals than currently is the case (para 3.3.1).
 - A full assessment of impact of the proposals on ‘accidental employers’ caught up in the full rigours of PAYE, such as those in receipt of Direct Payments who employ carers (para 3.4.2).
 - A review of the benefits legislation to evaluate areas where the fundamental calculation and assessment of benefits could be simplified – particularly for those on the lowest incomes – not just the process by which tax is collected on them (para 3.4.3).
 - Further guidance to be given to employers and employees to determine status, which in turn will help to ensure that the correct tax treatment is applied at outset (para 3.5.2).

- An assessment of the impact of payrolling on small firms, the result being that additional help should be provided to them in the transition if the proposals go ahead (para 3.6.1).
- A detailed review of the taxation of owner-managed businesses, which also links to the recent – and now deferred – proposals on *Income Shifting* (para 4.1.3).
- Further research as to the number of employees potentially affected by removing the earnings threshold, identifying where taxing benefits in kind might provide a disincentive to work (para 4.2.5).
- Further research to be done on the tax treatment of volunteers, how this interacts with other legislation such as the National Minimum Wage and what impact these proposals will have on this already complex area (para 4.3ff).
- A full disability impact assessment to be carried out, as disabled people are likely to earn less than non-disabled employees and therefore be disproportionately affected by removal of the earnings threshold (para 4.4.2).
- Rigorous testing of the proposed changes to be undertaken against typical arrangements that exist within the care-workers sector (para 4.5.1).

1.4. In summary, our view is that considerable further work needs to be undertaken to ensure the impact on relevant sectors has been fully assessed and the problems addressed in advance. Only then can an informed decision be taken on these proposals.

2. Introduction

2.1. The Low Incomes Tax Reform Group (LITRG) was set up by the Chartered Institute of Taxation (CIOT) to be a voice for the unrepresented in the tax system. We approach our response to this consultation from three main viewpoints, being that of:

- those in low-paid employment;
- volunteers and those that engage voluntary workers, where the line between what constitutes ‘volunteer work’ and ‘employment’ (and hence taxability of benefits and expenses) is blurred; and
- vulnerable individuals who become ‘accidental employers’, eg those in receipt of direct payments to facilitate independent living, who then use these to engage the services of carers.

2.2. Our response is divided into two sections, focusing firstly on the general proposal to payroll benefits and expense payments (section 3) and secondly adding further commentary on the potential impact of removing the £8,500 earnings threshold (section 4).

3. Payrolling benefits and expense payments

3.1. The objectives behind payrolling are basically laudable, but there is a range of issues requiring much more detailed consideration before a decision is taken:

- the impact on claimants of tax credits and welfare benefits must be fully considered;
- the transition would have to be carefully managed, for example ensuring employees receive *better* information and explanations relating to their expenses and benefits than they do at present;

- the position of ‘accidental employers’ – such as those in receipt of Direct Payments engaging the services of carers – must be reviewed and the impact on them minimised;
- better information must be provided on employment status so that employers can apply the benefits code correctly from the outset; and
- adequate support must be provided to small employers who might struggle to cope with the change.

We address each of these issues in turn below.

3.2. ***Tax credits and welfare benefits claimants***

- 3.2.1. Payrolling of benefits will cause a range of tax credits problems. Claimants of tax credits are required to report P11D/P9D figures on their tax credit claim forms. But not all taxable benefits are counted as income for tax credit purposes. The definition of ‘Employment Income’ for tax credits is set out in the regulations and includes a list of disregarded payments and benefits, many – but not all – of which are mirrored in the tax system (see *TC (Definition etc.) Regulations 2002 – SI 2002/2006*). The differences are subtle but significant. To payroll all benefits will therefore impose new additions to income for tax credits purposes; or introduce great complexity. It seems unlikely that a simplified P14/P60 would provide sufficient information to make the necessary distinctions for a tax credits claim.
- 3.2.2. Different definitions of income apply in each of the means-tested benefits, where (by contrast with tax credits) there is very little correlation with the tax system. Payrolling benefits may therefore raise issues for the DWP in administering means-tested benefits. It may be necessary to consider the knock-on effects for each benefit.
- 3.2.3. **We therefore recommend that a full review of the potential impact on tax credits and welfare benefits claimants is carried out before a decision is taken on payrolling. We suggest a working group of HMRC/DWP and the voluntary sector be established for this purpose.**

3.3. ***Information for employees***

- 3.3.1. There is also a wider communication issue to consider. Increasingly HMRC require unsophisticated taxpayers to “check” that things HMRC send them are correct. A failure so to do can lead to additional tax liabilities and/or penalties. This proposed change must have as one of its objectives that all information sent to low-income (and unrepresented) taxpayers will be clearer, more understandable and capable of being checked more easily than existing arrangements. We are not clear from examining these proposals that this will be the case. **We recommend that this becomes a requirement of any change.**

3.4. ***‘Accidental employers’, eg Direct Payments users engaging care workers***

- 3.4.1. On 31 January 2008, LITRG published its report entitled *Independent Living, Direct Payments and The Tax System*¹ (hereafter referred to as ‘the DP report’). Government policy encourages independent living² which has resulted in a system of Direct Payments being made to users, who in turn employ carers. The DP report looks at the resulting practical problems. Particularly relevant to this consultation is that recipients of Direct Payments often – almost by accident – become *employers* and therefore subject to the obligations conferred under employment law and PAYE regulations.

3.4.2. **We recommend that the DP report is considered in the context of this consultation, to identify any increased burden on this subset of employers.**

The report identifies that Direct Payments users potentially have access to a 'simplified' PAYE process, but in reality this is something of a misnomer. Payrolling of benefits and expense payments could present an additional hurdle for people already in a vulnerable position.

3.4.3. The DP report also considers some of the challenging benefits issues faced by this type of employer, such as identifying the difference between living accommodation and provision of board and lodging for live-in carers. Perhaps the reality is that it is not so much the P9D/P11D process that is onerous (although we do not dispute that this is a difficult and time-consuming task), but rather the identification and quantification of benefits that is the problem. **We therefore recommend that a review of benefits legislation is carried out to identify potential areas of simplification – particularly for those on the lowest incomes – to accompany this review of the reporting and tax-collection process.**

3.4.4. There are cross-over issues such as employment status (discussed below). With changes to working patterns in the 21st century such as flexible working, there must be corresponding changes in the tax system to keep pace. Rather than considering payrolling of benefits and expenses as a standalone issue, perhaps it is time to open up a wider debate on employment status, and consequently taxation of benefits and expenses?

3.5. ***Employment Status***

3.5.1. There are a range of complications to consider regarding employment status. Direct Payments recipients engaging the services of carers are one example. Our report identified the hazards of DP users attempting to determine whether their carer is working on an employed or self-employed basis. We understand that HMRC are currently undertaking a review of employment status. It is essential that such a review and this payrolling consultation should be considered together, especially as it relates to the complexities (particularly found in the charitable sector) surrounding the status of volunteers (as we elaborate below).

3.5.2. **We recommend that further work is done on the guidance given to employers and employees to determine status which in turn will help to ensure the correct tax treatment is applied.** The Employment Status Indicator (ESI)³ provided by HMRC is very much a work-in-progress; more work therefore needs to be done to improve this and related guidance.

3.6. ***Impact on small firms***

3.6.1. We are pleased to note that Annex B to the consultation acknowledges that one-off compliance costs are likely to fall more heavily on small firms, as the requirement to understand the procedures is the same regardless of employer size or number of employees. **We therefore recommend that the Small Firms Impact Test should identify this problem and suggest solutions.** The remedies could include HMRC offering a range of assistance if the changes are implemented, for example:

- Clear, accessible guidance in a range of formats (catering for small employers in printed form as well as via the internet);
- Free-of-charge workshops to train sole-traders and small bookkeepers on the changes.

4. Earnings threshold of £8,500

4.1. *General comments*

- 4.1.1. We appreciate that employers find the administrative burden of the earnings threshold onerous, but remain concerned about the likely impact of its removal without first conducting a full review and exploring other methods of offering exemption or relief to those adversely affected. We understand that even on retention of this threshold, there are no plans to up-rate it. The passage of time and corresponding effects of inflation already means that this threshold is irrelevant for all but the lowest paid; the very people who most need its protection.
- 4.1.2. From this, we can deduce that removal of the threshold will result in a tax increase on some of the poorest members of society. We understand that HMRC has also not yet considered what the knock-on effect might be for tax credits claimants and those claiming means-tested benefits. It is imperative to address these issues before taking any decision.
- 4.1.3. There is of course a link to owner-managed business where the earnings threshold might be used to some degree as a means of tax avoidance. But the question must be asked as to whether removing the earnings threshold for all employees is an appropriate way of dealing with this perceived avoidance. This comes back to calls previously made by our CIOT colleagues for HMRC to engage in a fundamental review of owner-managed business taxation⁴.

4.2. *Removal of the earnings threshold – impact on low-paid workers*

- 4.2.1. Many employers now offer benefits across the board as a way of attracting and retaining staff and ensuring remuneration is fair to all employees. Whilst this point is acknowledged in the consultation stage impact assessment (para 63), the statement at para 84 seems to contradict this by asserting that '*few part time workers receive benefits*'. In reality, we suspect that a great many part-time workers receive benefits; whether HMRC has the ability to extract data about them from their systems is another matter. Moreover, ever-increasing anti-discrimination legislation and case law – not only in the UK but across Europe – means that employers cannot afford to discriminate by failing to offer part-time workers the same benefits that are available to full-time members of staff.
- 4.2.2. Whilst it is quite true that the removal of this threshold is only likely to affect those in part-time work due to the National Minimum Wage, their resulting increased tax liability should not be ignored. In recent times, this same constituency has been hit by the loss of the 10% income tax band. Factoring in the 20% income tax rate on benefits together with tax credits tapering of 39% (up from 37%), such individuals could suffer a marginal tax rate of a punitive 59%.
- 4.2.3. This section of society is already treading a fine line between whether they are better off in work or on benefits. LITRG identified some of the difficulties faced by individuals in this situation in a report it published in January 2008 in partnership with Community Links and Child Poverty Action Group⁵. Taxing a benefit in kind which might have been previously excluded from charge could tip the balance against 'making work pay'.

- 4.2.4. Part-time employees working for – usually larger – firms where benefits are offered as standard to all employees will be affected. Take the example below.

Mrs A works as a part-time receptionist for a large firm. She is paid £7.50 an hour for 16 hours a week, ie £6,240 per annum. The firm offers everyone Private Medical Insurance and Mrs A takes it up. The benefit is £600 per annum to cover herself and her family (including her children). Her total earnings are her salary and benefit added together, ie £6,840. As this is less than £8,500, under the present regime, she pays no tax on the benefit. If the earnings threshold were removed, tax of 20% would be due on the benefit, ie £120 per annum.

- 4.2.5. **We therefore recommend that before any changes are implemented, research should be carried out to determine the number and extent of employees affected. This should identify where taxing a benefit in kind might provide a disincentive to work.** If this information is not available by reviewing HMRC's own data, then external research will be necessary.

4.3. **Volunteers**

- 4.3.1. Confusion can arise in the charitable and related sectors where people give up their time for no direct payment, but might, for example, receive minor expense payments or honoraria to cover out-of-pocket costs.
- 4.3.2. HMRC guidance on treatment of volunteers is given in the Employment Income Manual⁶ and is extended to participants in clinical trials⁷.
- 4.3.3. The difficulties start to arise however when organisations stray outside the realms of direct reimbursement of allowable costs. As the government is keen to encourage voluntary participation⁸, for instance as a way into employment for disabled people⁹, this is a problem which is set to increase. To facilitate voluntary participation of those from disadvantaged backgrounds, moves will have to be made towards increasing expense payments. The types of payment which might be made (or 'benefits' provided) could include those with significant cost attached, such as reimbursement of childcare costs.
- 4.3.4. It was clear to LITRG that government initiatives to encourage volunteering were likely to clash with the law surrounding taxation, welfare benefits and the National Minimum Wage and we commenced appropriate research at the end of last year. Our initial work has indeed shown this to be the case. We hope to issue a discussion paper in May/June to stimulate further debate, but we are happy to share our work to date with HMRC on a confidential basis. In our view, the £8,500 threshold discussion must take into account the position of "volunteers".

4.4. **Impact assessment – Disabled people**

- 4.4.1. The initial Impact Assessments annexed in the consultation document make no mention of the potential effect of the proposals on disabled people. HMRC has an obligation to consider this under its Disability Equality Scheme.
- 4.4.2. In its May 2007 Disability Briefing, the Disability Rights Commission (now enveloped in the Equality and Human Rights Commission) stated *'the average gross hourly pay of disabled employees is about 10 per cent less than that of non disabled employees'*. Disabled people are therefore more likely to be amongst the lower-paid members of society. It follows that they are likely to be disproportionately affected by

removal of the threshold and **we recommend that a comprehensive disability impact assessment should be carried out.**

4.5. **Care-workers**

- 4.5.1. We also believe there will be an impact on other sectors by removing the £8,500 earnings threshold. Care-workers are one such example. Our research in compiling the DP report (referred to above) indicated that a user might employ several carers on a part-time basis, earning at a rate below the threshold. Also, being based within a domestic environment throws up many interesting tax challenges, for example the sharing of meals or overnight accommodation. **We recommend that any potential changes should only be implemented after a rigorous testing against typical arrangements that exist within this sector.**

LITRG

17 March 2008

Endnotes:

¹ http://www.litr.org.uk/uploadedfiles/document/1_490_080131_DP_Report_final.pdf

² See the Independent Living Strategy from the Office for Disability Issues - <http://www.officefordisability.gov.uk/independent/strategy.asp>

³ <http://www.hmrc.gov.uk/calcs/esi.htm>

⁴ See <http://www.tax.org.uk/attach.pl/6578/7699/IncomeShifting%20final280208.pdf>

⁵ See 'Interact: benefits, tax credits and moving into work' - <http://www.litr.org.uk/reports/reports.cfm?id=483>

⁶ See EIM71100 - <http://www.hmrc.gov.uk/manuals/eimanual/EIM71100.htm>

⁷ See EIM71105 - <http://www.hmrc.gov.uk/manuals/eimanual/EIM71105.htm>

⁸ See 'Government responds to the Commission on the Future of Volunteering with £6million new funding' -

http://www.cabinetoffice.gov.uk/third_sector/news/news_stories/080307_volunteering.aspx

⁹ See Office for Disability Issues Annual Report 2006, Chapter 3, para 128ff - <http://www.officefordisability.gov.uk/publications/report/3.asp>