

LOW INCOMES TAX REFORM GROUP

IMPROVING THE OPERATION OF PAY AS YOU EARN (PAYE) Response to consultative document

1. Executive Summary

- 1.1. In this response we endeavour to consider the prospect of real-time information and centralised deductions from the point of view of the low-income, unrepresented taxpayer paying tax through PAYE, and possibly also in receipt of tax credits and/or taxable benefits.
- 1.2. Throughout recent PAYE upheavals, the unrepresented population has tended to suffer the most from the effects of error and delay in the system, with some losing tax which they have unwittingly overpaid, and others being faced with unexpected demands for large underpayments when they assumed they were paying the right amount through PAYE. Consequently, this population has the most to gain from a more accurate and reliable system, and if and to the extent that real-time information or centralised deductions can produce such increased accuracy and reliability, we welcome them.
- 1.3. But the taxpaying population is remarkably diverse, and any new system must – as far as possible – be suitable for all purposes, not just for a more or less homogenous majority. In a PAYE taxpaying population of some 30 million, it is important not to neglect minorities which can be of considerable relative size and importance. In section 4 below we therefore set out a range of minority interests that must be considered when looking to improve PAYE.
- 1.4. In section 5 we outline some of the systemic, technological and resourcing matters to be considered in introducing real-time information. We emphasise the need for old data-sets to be cleaned up, for the manual checking of past years' unreconciled data to be completed, and for NPS to bed in properly, before it is used as a platform for any new proposed system. We also set out briefly the lessons that need to be learned from previous IT failures, and where error and the consequences of processing delay may yet bedevil the workings of any new system.
- 1.5. We then examine where the limitations might lie. We concentrate particularly on tax credits and benefits, considering the feasibility of bringing them in to the real-time environment. We conclude that because of the widely differing measurement of income and bases of assessment in PAYE and tax credits, and to a lesser extent PAYE and traditional benefits, any such integration could only ever take place under a radically reformed tax and benefits system. That said, if a new common income

definition were fully thought through, and any new system were capable of analysing the income of couples (for tax credits and benefits) into individual incomes (for tax) and vice versa, there would be considerable cost savings and benefits of simplification from a common integrated base.

- 1.6. Finally we consider centralised deductions, and the vital issue of who would be responsible for any errors in deduction. We would not wish to see a return of Extra-Statutory Concession A19-type arguments in an environment where the individual taxpayer had little or no control over the accuracy of deductions, and no documentary means of checking.

2. Introduction

2.1. *About us*

- 2.1.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes.

- 2.1.2. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

2.2. *Our response*

- 2.3. We generally welcome this attempt to improve the operation of PAYE and make it more accurate. With a view to aiding the discussion and next stage of consultation, we also identify some of the problems and limitations in the proposed changes, particularly from the perspective of unrepresented taxpayers on a lower income.

3. General Comments

3.1. *Modernising the system*

- 3.1.1. The main difficulty of recent years is that expectations of the PAYE system have outstripped its capacity. A system designed to keep track of employment income or pension income from one source has been stretched to embrace simultaneously income from multiple employments, pensions and other sources, and more recently to process tax and tax credit debts in addition.
- 3.1.2. While PAYE was originally designed for a very different society from that of today, with perhaps simpler and more stable working patterns, income profiles and social norms, it still has potential to ensure that approximately the right amount of tax is deducted progressively during the year. The flaws that have become apparent in recent years are not inherent weaknesses in the system, so much as the increasing inability of the computer infrastructure and HMRC's processes to respond to present day life and work, and insufficient resources being applied to its day-to-day operation. Given that labour-intensive management of the system is no longer affordable, the only option remains reform of the technological base, a process that has started with

the advent of NPS and could well continue with what is proposed in this document.

3.2. ***Details and unearthing hidden problems at an early stage***

- 3.2.1. The discussion document is a high-level survey of the possibilities of real-time information (RTI) and centralised deductions (CD) to make the PAYE system more accurate and capable of assimilating and analysing greater quantities of data. It does not descend into minute detail, and much of the data it quotes is approximate. However, it is important not to neglect the minority interests or the possible obstacles that could emerge from a more detailed consideration (see 4 below). While we welcome the broad thrust of this paper, we concentrate in this response on what preparatory work needs to be done to ensure a good outcome for unrepresented taxpayers, who have been the main sufferers from malfunctions of the PAYE system to date; and also where implementation of RTI/CD could go wrong if such detail is not properly thought through.

3.3. ***Public perception***

- 3.3.1. Finally, we believe the public generally hold the view that PAYE is a virtually error-free means of paying tax, yet in truth in its present form it can only ever be approximate.
- 3.3.2. The increase in recent years in overpayments and underpayments from past years being uncovered through delayed manual checking of records that have not reconciled automatically is beginning, just now, to bring home to a wider public the real difficulties experienced by unrepresented taxpayers, mostly on low incomes, who either lose money through missing the opportunity to reclaim tax they have overpaid, or suffer hardship through being obliged to pay arrears they were not anticipating.
- 3.3.3. HMRC's hard line in operating Extra-Statutory Concession A19 leads to resentment from a public hitherto reliant upon HMRC and Government to get things right, and a breakdown in trust. If the proposed new system enables HMRC to regain some of that confidence, and a reputation for accuracy and fairness, that will be welcome; but much will depend on HMRC's attitude to the question of whose responsibility will attach to such error as may remain in the new system (for, as we warn below, even it will not be totally free from the possibility of error or delay).
- 3.3.4. In any event, HMRC will need to invest time and effort in communicating PAYE changes to taxpayers so that they understand what they mean for them and what their obligations are. Furthermore, without the help currently given by employers, HMRC would need to invest more in their Contact Centres.

4. **A system fit for all**

- 4.1. We list below some of the situations and minority interests that must be considered in order that any new system may achieve a high degree of accuracy and reliability for all PAYE taxpayers.
- 4.2. ***Movements in and out of the UK***
- 4.2.1. The migrant workers population, their movements in and out of the country, and the broader procedures associated with such movements must be addressed. There are numerous instances where people in such circumstances are served poorly by the current system

4.3. ***Life events***

- 4.3.1. Improved processes creates potential to deal much more efficiently with “life events”, for example turning 16, getting a NINO for the first time, moving on and off benefits, obtaining a new source of income on bereavement such as an inherited pension etc.

4.4. ***PAYE treatment of state benefits***

The DWP are not required to apply PAYE to the state pension and some other benefits such as carer’s allowance, and do not operate full PAYE on other taxable benefits such as jobseeker’s allowance and contribution-based employment and support allowance - often creates problems for taxpayers.

4.5. ***Small employers and direct payments users***

- 4.5.1. Small employers and direct payments (DP) employers are likely to need extra support in moving to RTI.
- 4.5.2. If however the new compliance measures associated with implementing RTI with the larger employers are effective, some of the income received earlier than currently could be earmarked for designing innovative ways to help small employers operate PAYE in a RTI environment. HMRC in partnership or alone could develop an RTI system for use by DP employers. The local authority/DP support services who hold the money could integrate straight into it so that the DP user has all the control over whom they employ but none of the worry of operating PAYE. But there would need to be time allowed to work on such ideas by building them into the planning stage and not leaving it to an afterthought.

4.6. ***Digital exclusion***

- 4.6.1. Employees who are paid in cash or by cheque and also their employers who may be “digitally excluded” need particular attention. Inability to engage with the digital world may be because they have a disability or condition precluding use of computers, or are “exempted filers”.
- 4.6.2. The full impact assessment to be completed in October 2010 must address these types of issues. Such employers may well include those employing the low paid (farm workers, casual and seasonal labourers). There are no actual statistics on the size of this segment in the discussion document and we would like to see further investigation of this group of employers and how they would be affected. Any new PAYE system must be able to ensure that an employee moving from an employer who is fully IT serviced to one where there is no IT suffers no disadvantage, and vice versa – indeed some employees may work simultaneously for an employer who is computerised and one who is not; for example, someone might be working as a carer for a DP employer exempt from electronic filing but also have another job with an employer running a computerised payroll.
- 4.6.3. There is a sector who still do not have, or will have difficulty in obtaining a bank account, including bankrupt taxpayers, those with a poor credit rating or history, or who simply do not meet the banks “criteria”. Although there is a drive by the government to ensure that everyone has access to a “basic bank account” it may not include everybody in this position. It is more likely to be the lower paid who have these difficulties.

5. Computer systems/Technology/Resources

- 5.1. For many decades PAYE was operated through a computer system that was poor at matching different sources of income to the same individual, particularly where the data itself was unreliable. Hence the volume of records to be manually checked has grown cumulatively year by year, with some 18.2 million waiting to be checked at the time of the NAO report into HMRC's 2009-10 accounts.
- 5.2. While the new NPS system has not been without its teething problems, largely due to unclean data already in the system, it is hoped that as NPS beds in the data should become gradually cleaner. By the time it is intended to implement the proposals in the consultative document, it is hoped that NPS would be working well as a good platform of stable data.
- 5.3. However, it is essential that adequate resources are directed to ensuring a clean start to any new system, and that new and existing data is continually checked for accuracy. This will involve a major effort at finishing the backlog of manual checks waiting to be done on old data. If the cost of carrying out this exercise is skimmed, the remaining unclean data will undoubtedly clog up the works of any reformed system and prevent it attaining its objective of greater accuracy. This could prove vastly more expensive in the long run.
- 5.4. So far as possible, lessons must be learned from past IT failures, and steps taken to minimise recurrence. The temptation to cut costs must be avoided, as it will not lead to greater efficiency in the long run. In particular:
 - Any new system must have enough operator access availability to minimise delays not only in its normal day to day running, but even more when things go wrong;
 - It must be thoroughly tested at all stages during implementation, with any guarantees given under old computer systems being carried forward;
 - There must be robust contingency plans where any new system is expected to interact with automated bank systems such as BACS and/or CHAPS;
 - There must also be a truly "one stop record" where all areas of HMRC have access to all the information, and thus the customer can be fully served at one point (as envisaged in para 3.16 and 3.17 of the discussion document);
 - Enough time must be allowed for system development before launch (the introduction of tax credits is an object lesson in the likely consequence of a rushed job).
- 5.5. There are many reporting issues which will need to be addressed to ensure that RTI is comprehensive and complete. Many computerised payroll packages will only generate employee records where there is income subject to PAYE and/or NIC leaving those under the earnings limits to be dealt with by way of a P38A declaration. Also a student's form P38S is only submitted when called for by HMRC. It would be necessary to consider further how the information from these sources would be captured in real time.

6. Likely limitations of the proposed system

- 6.1. While any new system will have the potential for greater accuracy simply by starting off with a clean set of data, there will still be an element of delay in implementation of code numbers when a person changes job. Therefore the potential of an under or overpayment will still exist. There will always be situations where irregular payments arise – such as employer mistakes that have to be corrected later.
- 6.2. Where a person on a low income is affected by such errors or delays, any errors would have to be rectified promptly, perhaps with some sort of mechanism for immediate “emergency payments” or adjustments to be inbuilt. The alternative would be a build-up of such errors year by year, unless picked up by manual checking in the interim, and unseemly arguments about whose responsibility it is to reclaim the overpaid tax within set time limits, and spot the accruing underpayments that the system is unable to rectify.
- 6.3. It is also possible that HMRC could delay in processing the data (cf tax credits, where data processing can take up to 30 days). Unless this is done immediately (i.e. overnight) then there will still be the possibility of an over or underpayment. What kind of assurance, “target” or charter statement would there be for time of turnaround?

Self assessment

- 6.4. Consideration will have to be given as to how any new system works in conjunction with self assessment, both in filing returns, and in collection and payment of tax. If pre-population of employment earnings is to be a feature, then we would imagine the self assessment returns would need to be issued much later than 6 April, assuming there would still be some kind of end of year reconciliation process required.

Devolved Governments (Scotland, Wales and Northern Ireland)

- 6.5. If any of the devolved governments vary tax rates then any new system would have to be able to be varied without loss of service, particularly where employees move to or from employers in or out of devolved tax areas.

Responsiveness to changing circumstances

- 6.6. Paragraph 3.3 of the discussion document suggests that RTI would somehow overcome the issues of estimated income but it would not entirely do so. Historical data might be accurate but future data will still remain uncertain. Job changes, promotions, illness, pregnancy, death, strikes, sales of business etc can all affect the annual outcome. Even overtime might present a challenge.

Interaction with tax credits and benefits

- 6.7. It would be impossible for tax credits to be dealt with in the same RTI environment as PAYE income for two reasons. First, the measurement of income is fundamentally different. Secondly, the unit of assessment is different – individual for tax, against couple for tax credits.
- 6.8. PAYE, as is well known, should operate on a cumulative basis throughout the year. The measurement of income for tax credits purposes, on the other hand, depends upon a comparison, at the end of a tax year, between the income for that year (the

‘current year’) and the previous (‘preceding’) year. If current year income is not less than preceding year income, or exceeds it but by not more than the disregard (currently £25,000), then the current year income is deemed to be equal to preceding year income. At that point it is deemed to accrue evenly day by day over the period of the current year, with 1/365 (or 1/366) of the total accruing during each day of the period. That is a simplified explanation which does not take into account the division of a tax credits year into ‘relevant periods’ during which a claimant’s circumstances remain the same, but it is enough to demonstrate how radically differently income is measured for tax credits and PAYE purposes.

- 6.9. Para 4.18 says that access to real-time data would remove the need for benefits and tax credits claimants to notify changes of income. However at present there isn’t any need to notify changes of income except at the year end. There is no requirement for claimants to report either increases, or decreases, in income during the course of a year, and sometimes it may not be to their advantage to do so. If disregards are to be reduced it will be important to retain that option. But if RTI were to be applied it would override any such option.
- 6.10. Tax credits income in a joint claim is the joint income of the couple, while for tax purposes the income to be determined is that of each individual. The complexity increases if a taxpayer/claimant forms a relationship or finishes one, or is in more than one relationship, during a year. The system will somehow need to analyse individual income data into couples, sometimes more than one in the course of a year. The challenge would be all the greater if one member of the couple is an employee in PAYE, and the other is self-employed.
- 6.11. There might be fewer challenges in including taxable DWP-administered benefits in RTI, even though one is dealing with fixed award periods, generally of a week at a time, rather than a cumulative process. But there remain problems when we consider that income definitions for tax purposes are not aligned with tax and tax credits. Moreover, the same problems would remain in analysing individual income data for tax purposes into joint income data for couples (and the definition of a couple can be different for tax credits and benefits). Similarly, rationalisation of definitions and legislative change will be required before any payrolling of benefits would be possible.
- 6.12. There would have to be a real-time feed between DWP and HMRC systems. That would present an ideal opportunity to make sure that all the taxable data gets fed in for completeness – including those currently omitted, like carer’s allowance. As so many coding errors affecting low-income pensioners stem from the fact that the state retirement pension (SRP) is taxable but not paid through PAYE, a real-time feed of SRP information should be of considerable benefit to the pensioner population. There would of course need to be certainty that NPS would be able to cope with a massive increase in data flows for all the pensioners who are genuinely non-taxpayers because their income is too low. We understand that HMRC have traditionally ignored these people because the systems have never been able to cope with the numbers, so we hope that technology has now moved on sufficiently.
- 6.13. However, if the benefits and tax credits system were reformed along the lines set out in the DWP consultation document *21st Century Welfare*, RTI could build a basis for such a reform that might ultimately lean towards integration. All the benefits and tax credits rules would have to be rethought to fit on to an RTI income platform. Yet it must make administrative sense and eventually produce cost savings to align the sources of income for tax and benefits purposes.

7. Centralised Deduction

- 7.1. The proposal in the discussion document is that a gross amount is notified to HMRC, who will then be responsible for deducting the tax. However it is not stated how this would affect and/or impact on employers' NIC contributions.
- 7.2. It is said that HMRC would be responsible for ensuring deductions were correct, and (para 5.12) that individuals would no longer need to understand tax codes. But if deductions happened to be wrong, and the same error persisted year after year, yet the taxpayer no longer had the documentary means of checking in the form of P2 notices, payslips, and the like, then those who calculated and implemented the deductions should surely bear responsibility, not the individual taxpayer (provided the taxpayer had given all the right information to the right people at the right times). It is arguable that in such circumstances the taxpayer would have a legitimate expectation to that effect, which would absolve him or her of responsibility for any shortfall.

LITRG
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