

**Alignment of Income Tax and National Insurance – Consultation by the Office of Tax
Simplification (OTS)
Response from the Low Incomes Tax Reform Group (LITRG)**

1 Executive Summary

- 1.1 LITRG welcomes the opportunity to contribute to the OTS review into the closer alignment of income tax and National Insurance (NIC). We support a closer alignment between income tax and NIC as long as this leads to some simplifications which promote a better understanding of the Pay As You Earn (PAYE) and NIC regimes, particularly amongst unrepresented taxpayers.
- 1.2 In our view, key areas where there is significant scope for improving the system through greater alignment include the basis for calculating NIC, the basis on which liability to both income tax and NIC arises for employees on their employment income, and greater parity between self employed and employee NIC. Any changes must remain fair to all.
- 1.3 The impact of any changes to the NIC regime on the benefits system must be fully considered and understood, and protective measures introduced if necessary.

2 About Us

- 2.1 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. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

- 2.2 LITRG works extensively with HM Revenue and Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 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.

3 Detailed response

3.1 *Introduction*

- 3.1.1 We have considered the key questions raised in the open consultation document published on 19 October 2015 and have addressed those which are relevant to the constituents we represent below under the same subheadings:

3.2 *Background (1.1)*

- 3.2.1 Any simplification of the UK tax system is welcomed and closer alignment of income tax and NIC should achieve this. However distortions arise in the current system as a direct consequence of the PAYE and NIC rules, for example businesses using 'self employed' workers rather than taking on employees. This avoids both the employer's NIC charge and also the tax compliance and employment law obligations that arise with employees; these can be overwhelming for small businesses, particularly since the recent introduction of RTI and the imminent arrival of auto enrolment. The introduction of the National Living Wage may also tempt businesses towards self employed workers rather than employees.
- 3.2.2 Aligning the tax and NIC rules in such a way as to curb such distortions would produce a more 'level playing field' when it comes to employment, particularly for low income workers who sometimes find themselves with no option but to take on work on either a self employed basis (and so with no employment protection) or via some kind of intermediary such as an umbrella company. This could be particularly important for workers claiming universal credit in due course as the minimum income floor will be applied to self employed workers but not employees.

3.3 *The present structure of income tax and NIC (1.2)*

- 3.3.1 We do not believe the present structure of PAYE and NIC is well understood by taxpayers, particularly those who are unrepresented. For example, difficulties arise as a consequence of the different bases for calculating NIC (periodic and per employment) and income tax (cumulative, annual), the differences in calculating directors' NIC (usually annual) and employees' NIC (periodic), and establishing employment status for PAYE and NIC purposes. For those who can afford it, risk is managed by engaging professional advisers. For those

who cannot afford professional advice, a disproportionate amount of time is spent trying to minimise the risk of error at the expense of concentrating on developing and managing the business.

- 3.3.2 The current regime significantly impacts taxpayer behaviour as it encourages self employment due to the lower rates of NIC for the self employed individual and no employer's NIC for the business. The current NIC regime also encourages incorporation to minimise employer's NIC liabilities.

3.4 ***Distinctions between income tax and NICs – definitions (1.3)***

- 3.4.1 The different definitions of earnings for income tax and NIC cause confusion. For example, an employee has an income tax charge associated with a benefit in kind from an employer but there is no employee's NIC charge; there is an employer's NIC liability on some benefits in kind but not all, pension contributions do not always attract NIC relief.

- 3.4.2 If there was a move towards greater alignment in this area, for example, applying NIC to benefits in kind, then the consequent increase in NIC liabilities for employees and employers should be phased in over a transitional period, preferably with some transitional relief provided to lessen the immediate impact of any increases. A strong education and communication programme would also need to be undertaken over a reasonable transition period to highlight any changes. Some employees would be able to pay NIC on benefits in kind via the payroll if their employers were operating the voluntary payrolling of benefits.

3.5 ***Distinctions between income tax and NICs – administration (1.4)***

- 3.5.1 We are of the view that class 1 NIC should operate on an annual cumulative basis in the same way as PAYE, including for directors. It would then be better understood. Self-employed class 4 NIC is already calculated on an annual basis and so would be consistent with this principle. However such a change may create an NIC liability where there currently is not one for workers with low income from two or more part time employments where weekly/monthly pay is below NIC thresholds for each employment. Provided National Insurance credits for contributory benefits are accumulated in these circumstances this should be acceptable.
- 3.5.2 An annual cumulative basis of calculation for NIC would inevitably mean that a reconciliation would be required at the tax year end for NIC purposes as well as for PAYE. This would clearly have resource implications for HMRC.
- 3.5.3 As there are fewer variables with NIC liabilities than there are with income tax, a coding system for NICs would not need to be as complex as that for PAYE. It would be preferable to issue NIC coding notifications by exception, e.g. to notify employers when an individual ceases to be liable to NIC due to age, as this would reduce the number of NIC notifications required. It would minimise the administration for HMRC if a modification could be made to

the existing PAYE coding notices, perhaps in a similar way to identifying Scottish taxpayers, with a prefix to the code number.

- 3.5.4 Alignment of thresholds and income bands for income tax and NIC would be a welcome simplification if it did not result in a significant increase in overall liability, however in view of Real Time Information (RTI) requirements, the majority of payrolls are now computerised, and therefore any differences in rate bands, etc. would be written into software. Consideration must still be given to those employers who file paper returns (e.g. some care and support employers) and are unable to use software to manage their payroll.

- 3.5.5 Moving NIC over to an annual cumulative basis may have implications under the broad agreements for the co-ordination of social security across EU Member States, where entitlement and competency is linked to periods of insurance in a relevant Member State.

3.6 ***Employed v self employed (1.5)***

- 3.6.1 The same treatment for NIC purposes for both the employed and self employed would be a simplification and may also impact on taxpayer behaviour as it would reduce the financial benefits of self employment, but the differences in the income tax rules would still remain, e.g. treatment of business expenses.
- 3.6.2 As class 2 NIC is due to be abolished, aligning NIC in this way would presumably mean increasing the rate of class 4 contributions and so this would lead to a large increase in contributions for the self employed. In our view, the corollary to this should be a commensurate increase in their entitlement to contributory state benefits such as Jobseeker's Allowance (JSA).
- 3.6.3 Protection for the groups of low income self employed who are currently able to pay voluntary Class 2 contributions (where their profits are below the small profit threshold) will need to be considered. Paying voluntary Class 3 contributions is an extremely expensive option and would leave them in a far worse position than the current system. Failure to make such a provision could lead to a greater dependence on other benefits at retirement at greater cost to the state. Similar protection for those with small profits and entitlement to working tax credit, who can currently receive National Insurance credits will also need to be given consideration.

3.7 ***Employers NIC (1.6)***

- 3.7.1 For small employers who generally do not provide benefits in kind to their employees, the employers' NIC regime seems to be begrudgingly accepted if not generally understood and the introduction of the employment allowance to mitigate this expense for small businesses was welcome.
- 3.7.2 The main areas to be addressed if aligning the tax bases for individuals' employment income and employer's NIC are around the treatment of benefits in kind, business expenses, termination payments and pension contributions.

3.7.3 In our experience, most employees do not have any awareness or understanding of employer's NICs.

3.8 ***General admin (1.7)***

3.8.1 We would expect that any alignment would make compliance easier once any transitional periods have ended, and should simplify record keeping to some degree. We would stress that in an age of increased digitalisation, and HMRC's 'digital by default' strategy, suitable provision should be made for those who are digitally excluded.

3.9 ***The contributory principle (1.8)***

3.9.1 In general, the contributory principle relating to NIC does not seem to be well understood by individuals, many people believing their NIC go towards funding the NHS or their state pension. Any steps towards greater alignment should still mean that individuals' contributions can be identified so that the contributory principles can be retained.

3.10 ***International experience (1.9)***

3.10.1 No comment.

3.11 ***Finally (1.10)***

3.11.1 We believe changes to the following areas should be the main focus to deliver greater simplification and fairness:

- (a) Annual cumulative basis of calculation for NIC with an annual reconciliation, and National Insurance credits for lower paid part time workers by combining employments
- (b) Same scope of liability for income tax and NIC purposes in respect of employees' employment income
- (c) Closer alignment of self employed and employee NIC and similar entitlement to contributory benefits

LITRG
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