

Integrating the operation of income tax and National Insurance contributions Response by the Chartered Institute of Taxation

1 Introduction

- 1.1 The Chartered Institute of Taxation (CIOT) is pleased to respond to the Government's call for evidence: a first step to consulting on the integration of the operation of income tax and National Insurance contributions (NICs).

2 Executive summary

- 2.1 The CIOT has long argued that the inefficiencies and administrative burdens caused by the separate operation of the income tax and NICs systems needs to be addressed and that the integration of the two systems should be a primary aim. Such a move has the potential to reduce the administrative burdens faced by all those who have to deal with the systems.
- 2.2 It does seem to us unhelpful to have different definitions of earnings for income tax and NICs purposes (not to mention for tax credits and benefits purposes). Indeed, we think that the time has also long passed when the UK populace sees NICs as intrinsically different to tax; additionally the idea of the contributory principle has been very much eroded over the years. Most consider that NICs are essentially a tax by another name and we think it would serve the interests of simplicity and integrity of the tax system to acknowledge this by aligning their operation as far as possible.
- 2.3 We believe that the resulting administrative savings would benefit HMRC, as well as employers and the self-employed. In fact, we would add 'Reducing burdens on the self-employed and other individuals' as an additional 'Rationale for reform' at paragraph 1.14 in the consultation document.
- 2.4 The consultation process presents a great opportunity for real simplification in an area where the nettle has not previously been grasped. In particular, to:
- Remove differences in the definition of earnings for income tax/PAYE and NICs purposes;
 - Align the largely weekly/monthly system for NICs to the annual, cumulative system for income tax;
 - Review the NICs categorisation of earnings regulations to determine whether the policy rationale still applies;

- Align the collection and penalty regimes for NICs and income tax;
- For individuals, bring NICs within the scope of Self Assessment (eg for payment of Class 2, and deferment and annual maximum claims, etc); and
- Rationalise the HMRC Employment Income and NI Manuals once a new streamlined approach is in operation.

2.5 Over the longer term we think that it would also be possible to:

- Align thresholds with those that apply for income tax purposes;
- Simplify the varying types of contribution of NICs (eg by merging Class 2 and Class 4 for the self-employed);
- Introduce a common definition of 'residence' and (if retained) 'ordinary residence' in line with the proposed new statutory residence test for income tax;
- Review the NICs rules which apply to mobile employees around the 52 week rules for inbounds and outbounds, and consider alignment to the tax rules;
- Introduce 'sourcing' rules for NICs in a similar way as currently apply for earnings from employment for mobile workers; but
- Otherwise, keep NICs separate from income tax in terms of the UK's obligations under the EU social security treaty and bilateral reciprocal agreements.

3 National Insurance

- 3.1 The income tax and NICs systems have been developed separately for almost 100 years (ever since the introduction of National Insurance under the National Insurance Act 1911). Even though National Insurance was transferred to the (then) Inland Revenue in 1999, both systems continue to be operated separately. Even though there is now some commonality between the PAYE and NIC systems, the subtle differences all too often lead to simple mistakes.
- 3.2 We believe that it is no longer necessary to maintain the separate 'machinery' (ie legislation, definitions, etc) to assess and collect NICs. Instead, we would recommend that the definitions of earnings, deductions, etc be aligned with the income tax definitions in the Income Tax (Earnings and Pensions) Act 2003 (ITEPA) and the Income Tax (Trading and Other Income) Act 2005 (ITTOIA), and that an annual basis of reckoning for NICs be introduced.
- 3.3 A single set of rules would dramatically reduce the administrative burdens/cost on businesses, employers, individuals and HMRC. For example, much of the NICs administrative structure would no longer be required, which would free up resources to be redeployed to tackle other areas and also meet Government spending reduction targets. It would also enable much of the NICs legislation to be repealed from the statute book; in the 2011/12 Tolley's this currently runs to some 550 pages (excluding EC material and press releases).
- 3.4 One practical issue this raises is the mechanism for making changes to the two levies. Income tax changes are effected through the Finance Bill; NICs through social security legislation. Whatever the historic justification for this dichotomy, it needs to be modernised and rationalised so both can be changed in the Finance Bill process.
- 3.5 Our suggested approach would retain the existing position whereby a separate NIC charge is levied on earnings, but it would significantly simplify the calculation of the charge. It would also preserve the contributory principle (and the ability to pay voluntary contributions) – albeit that this has been very much eroded in recent years (and may be

further eroded given the suggestion of moving towards a flat rate pension). That said, we would recommend that, as part of the review, the differences in the nature of payments of income tax and NICs be considered (eg the effect of various contributions and obligations under international agreements).

- 3.6 In effect, we propose that NIC be computed as a percentage of the amount charged to income tax as i) employment income, as defined by ITEPA, or ii) as self-employment income, as defined by ITTOIA, as appropriate, and that the specific NICs calculation and payment rules be discarded. This would allow the current timing conflicts inherent in the two systems (ie arising from the annual basis for income tax and the largely weekly/monthly basis of NICs) to be eliminated. There would also be a reckoning up at the end of the tax year as now applies for income tax purposes, which for example would assist individuals with more than one employment who may have overpaid NICs under the current system.
- 3.7 This approach would also negate differences over, for example, tips and troncs, holiday pay schemes, AMAP car mileage reimbursement rates for over 10,000 miles per annum, and the need to reproduce a series of exemptions from ITEPA (which still give rise to differences, eg in the treatment of motoring related expenses). It would also obviate the need for separate NICs regulations following amendments to income tax legislation in Finance Acts. For example, to apply NICs to 'disguised remuneration', where even with the NIC regulations there is, in places, a lack of alignment between, for example, the reliefs in the Finance Act legislation and the NICs regulations.
- 3.8 There are clearly some major differences at present over income tax and NICs calculations. Two key ones are:
- Pension contributions
 - Termination payments
- It may well be that one or both of these should remain as specific, known differences in treatment. But any differences should be the result of deliberate policy decision, not accident of process.
- 3.9 We think that this reform should proceed on a 'revenue neutral' basis. It should be all about saving administrative costs (on all sides), not raising (or reducing) revenues. That said, we think that the changes necessary to effect the reforms we have outlined will be a mix of raising and costing revenue. There will be some winners and losers – but it will be important to demonstrate that the overall effect is revenue neutrality. Thus to pick up a point from our previous paragraph, we can see that one reason for considering maintaining a difference between income tax and NICs over termination payments¹ is to avoid increasing employers' costs in the current economic climate.
- 3.10 We would suggest that, as part of the consultation process, the special rules² that treat certain categories of workers, who would be self-employed under normal case law principles, as employees for NIC purposes be reviewed to see whether the policy rationale underpinning the regulations is still appropriate.
- 3.11 We also suggest that the collection mechanism for Class 1 NICs be aligned with that for PAYE and that the same penalty regime should also apply. By way of example, when HMRC are pursuing NIC and there is a danger of an amount falling out of time (6 years as opposed to the statutory limits that apply under the Taxes Acts) they need to lodge writs in the County Court which seems an unnecessarily convoluted procedure; why not apply the same approach as applies for income tax?

¹ For termination payments subject to tax under section 401 ITEPA, currently, no NICs arise in relation to such payments whereas (normally) a limit of £30,000 applies for income tax purposes.

² The social security (categorisation of earners) regulations 1978.

- 3.12 We do not however see any particular need to disturb the systems of Class 1 NIC and Class 1A NIC which apply to cash payments (and readily convertible assets, etc) and benefits-in-kind respectively. With the calculation of the Class 1 charge based on taxable cash earnings, this will in any event simplify things hugely – and the Class 1A charge is of course already linked directly to the taxable amount charged as a benefit-in-kind. (Although our proposed approach would remove remaining differences whereby some P11D benefits in kind can be liable to Class 1 rather than Class 1A NIC, eg NICs treatment of education costs for children of employees where the employer is invoiced direct.)
- 3.13 The impending introduction of Real Time Information (RTI) makes it all the more important that the system is as simple as possible to operate.

4 The Self-employed and those with multiple employments

- 4.1 The evidence being sought ignores Class 2 and Class 4 contributions, and concentrates on employers and employment income. However, any changes to the operation of income tax and NICs will also need to consider the impact on the self-employed as well as employers and employees.
- 4.2 We have previously suggested that Class 2 and Class 4 NICs should be merged (see our response of 6 June 2008³ to proposals for ‘Improving the collection of NICs from the self-employed’) and would recommend that this be considered as part of the current consultation process.
- 4.3 Individuals with a self-employment and an employment or with more than one employment can find that they overpay NICs during the year. In some cases, they are able to make a deferment application. In others, they are required to overpay and then have to make a separate repayment claim to HMRC’s NI Contributions and Employment Office (NICEO). Those on low incomes do not have to pay Class 2 NIC and can apply for exception from payment in advance. These separate applications are labour intensive and can be a significant burden for the self-employed.
- 4.4 Another burden for the self-employed is the different treatment of losses for income tax and NIC purposes, where a claim is made to offset a loss within the tax year. Aligning the rules here would reduce record keeping burdens and the opportunity to make mistakes, which are easy to make due to software often requiring manual adjustments to deal with the carry forward of losses for NIC purposes. .
- 4.5 We think that NIC should be fully integrated into an individual’s annual self-assessment (SA), alongside income tax, through the SA process. This would enable an annual check on whether the right amount of NIC had been paid, the various applications (mentioned above), and labour intensive calculations that many self-employed currently need to make could be eliminated.
- 4.6 Question 1.2 at the end of the consultation document asks about key differences between income tax and NIC. For the burdens on the self-employed, which ought to be listed here, it is the fact that NIC is not fully integrated into SA.
- 4.7 Question 1.3 asks what would be the most important step to reduce the effects. Fully

³ Available at <http://www.tax.org.uk/tax-policy/public-submissions/2008/improving-the-collection-of-nics-from-the-self-employed-ciot-comments>

including NIC in SA would have a significant impact. It would remove the need for a huge number of forms, reduce burdens on the self-employed and on HMRC who need to process these forms and overpayments.

- 4.8 Question 2.4 asks about the time taken to deal with certain employment NIC processes. We think HMRC should also enquire about the amount of time spent on NIC by the self-employed and their agents. Much of this could evaporate under SA.
- 4.9 Question 2.11 asks about software packages. Most software packages ignore the issues highlighted above (deferral, exception and repayment applications) because they are not part of the SA process. Integrating the processes into SA would allow them to be automated and have an even greater impact on burdens for HMRC, the self-employed, employees and their agents.

5 International

- 5.1 We wonder whether the '52 week rule' for inbound and outbound workers (regulation 145 of the social security regulations 2001/1004) really needs to be retained. When a UK employer second an employee to another country outside the EU, they must account for NICs for both employer and employee if certain conditions are met as specified in regulation 145(1). This means an employee is given a P45 for tax purposes as PAYE has ceased but the employee must be retained on the payroll for NICs purposes.
- 5.2 Likewise, when an employee comes to the UK to work, there is a NICs 52 week exemption in certain circumstances. The precise meaning of the words in regulation 145(2)(c) and beyond have been a source of confusion for many years. However, a newly arrived employee may be subject to PAYE but not NICs (because of the 52-week exemption) if he remains employed by his home employer and is merely seconded to the UK..
- 5.3 The 52 week exemption itself is also not clearly understood by all, ie if income is paid in week 52 that relates to week 53 it may be subject to NICs by virtue of regulations 30 or 31 but the exact application of these regulations is unclear. However, a payment for week 52 simply paid in week 53 is subject to NICs. Bonuses for the first 52-week period also seem to be subject to NICs based on the payment date and not when the earnings are earned.
- 5.4 We would suggest that consideration should be given to simply following the tax treatment instead.
- 5.5 We also think a similar approach could be taken on income sourcing for NICs purposes. In other words, align the NICs approach to that for income tax; once a cumulative annual basis applies for NICs we think this all becomes much easier. At present, we have bonuses apportioned for income tax purposes on an earnings basis so that where a bonus is paid after departure from the UK but in respect of duties performed in the UK, the apportionment basis has been agreed with HMRC for income tax but no agreement has been reached with HMRC for NICs.
- 5.6 We would suggest defining residence similarly for income tax and NIC purposes. The work on the new statutory residence test seems to us to be an ideal opportunity to do this. Currently, NIC is based not only on residence but also on presence, meaning that residence as a concept is virtually irrelevant. However, having residence as a basis for 'taxing' taxpayers and having it defined in legislation is at odds with having no definition within the NIC's legislation.
- 5.7 In addition, we also have the status of 'not ordinarily resident' within regulation 145 of the

NICs Regulations, again with no definition of what is meant by ordinary residence. If tax is to have a definition ordinary residence or have the term removed, NICs should follow suit.

- 5.8 Where there is a reciprocal agreement, or the EU agreement applies, we think the existing approach should be maintained. So the calculation and machinery around NICs is greatly simplified but as far as the UK's international obligations around social security are concerned, they remain exactly the same.
- 5.9 We would note that NICs and income tax are levied differently on share scheme income. If an option is granted to an employee when he or she is not subject to NIC, and that option is subsequently exercised when the employee is subject to NIC, it is not clear in all cases whether NICs are due. Income tax may be due if the option is granted 'in connection with' the impending UK duties but NICs may not be.
- 5.10 We would like to compliment HMRC on introducing Modified NICs to run alongside Modified PAYE. It is difficult enough to operate PAYE and NICs on a strictly correct basis for domestic employees. We would be concerned if this scheme was abolished to fit in with the requirements of RTI without something suitable in its place. For those with international dimensions, ie employer in one country and fiscal obligations in another country (or countries) the need for a common sense relaxation of the rules to enable the employer to eventually collect and pay over the right amount of PAYE and NICs is essential.

6 Further comments

- 6.1 HMRC maintain two separate manuals for employment income: the Employment Income Manual (EIM) and the National Insurance Manual (NIM). One consequence of this is that it is necessary to consult both Manuals to determine whether 'income' is subject to income tax and/or NICs (and which Class of NICs). We would suggest that there are administrative savings in merging the two manuals to form a single source of reference for the taxation of income from employment. Similarly, for the taxation of income from self-employment, the relevant parts of the NIM could be amalgamated into the Business Income Manual.
- 6.2 One advantage to adopting an annualised basis for NICs generally (directors, office-holders and the self-employed are already liable on an annual 'earnings' basis) would be the problem of 'ins and outs' within a year where people might be paying NICs for a few weeks only without accruing any contributory entitlements.
- 6.3 For example, a student who only works between terms can sign a P38(S) if they will earn under the personal allowance threshold and, so, not be liable to income tax. But the employer may still have to deduct Class 1 NICs even though those contributions are unlikely to be sufficient to gain entitlement to contributory benefits.
- 6.4 This is just one of the many manifestations of having different basis periods.
- 6.5 In adopting a single definition of employment income for NIC and income tax purposes it would be possible to eliminate some of the distortions arising from having an exemption in one system but not in the other.
- 6.6 For example, currently if an individual is appointed to a non-executive directorship and wants to donate his (or her) whole salary to charity via 'payroll giving' he or she would have to retain a small amount of salary to fund the employee NICs liability. (Of course, introducing a NICs relief for payroll giving would result in such donating becoming more advantageous than gift aid but the two schemes are separate at present anyway.)

- 6.7 We have already referred (at para 3.8) to the differences in treatment around pension contributions. A payment by an employer direct to an HMRC registered pension scheme is subject to income tax and NIC relief, whereas a contribution direct to a registered personal pension scheme by an employee is subject to income tax relief but not NICs. (Not that we are suggesting extending relief for personal contributions to NICs, which would be a major issue and necessitate the review of the whole basis of pension provisioning; we are simply illustrating a distortion currently present.)
- 6.8 Alignment of the rules for deductions would avoid many of these problems.

7 The Chartered Institute of Taxation

- 7.1 The Chartered Institute of Taxation (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.

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