



All-Party Parliamentary Taxation Group

Tax simplification in the United Kingdom

Real Time Information and the reforms to the PAYE system

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Foreword by the Chairman

Over the past year the British tax system has faced significant challenges, particularly the final introduction of Real Time Information (RTI) for the vast majority of small and microbusinesses who were still preparing for but yet to encounter the system when this report was first published.

In many ways though, the issues remain the same. In a changing world, PAYE remains ill-fitted to cope with the demands of businesses, in particular the small and microbusinesses who will drive growth and stimulate our economy. This leads to substantial difficulty for the vast number of business men and women across the UK, and discourages others from starting a business completely.

As Chairman of the All-Party Parliamentary Taxation Group, it is both disappointing and disheartening for me to say that there has been little progress. However, in order to achieve change and the better tax system we all strive for, it is important that all stakeholders in the tax process to raise issues when they occur and we are honest about our present situation.

The dealings of HM Revenue and Customs (HMRC) over the past year have continued to display the same issues raised in this report a year ago.

- **Workplace behaviour and work patterns continue to change but policy is yet to adapt.** Latest figures suggest that more and more people are choosing to run their own businesses, but the tax system is still a maze for these brave entrepreneurs and this needs to be addressed.
- **There remains a substantial challenge ahead to incorporate changing ‘in work benefits’ into the system.** Only time will tell if the introduction of the Universal Credit will be successful, but it is crucial that the need for greater communication of these changes is addressed ahead of the introduction if it is to truly simplify the system.
- **The bureaucracy of the system remains a crippling burden for small businesses.** RTI has, for many, proven to be not the simplification it was trumpeted as, but additional bureaucracy to cope with. HMRC are yet to see them truly address the concerns raised in their official report on the matter about the IT systems that caused problems for citizens inputting data.
- **There is still a clear lack of engagement with taxpayers.** We are yet to see any true progress made in this area. Indeed just this month it was reported that 300,000 people signed a petition against the proposed plans (discovered in April) that would have allowed HMRC to sell taxpayers data to third parties. These plans were a huge mistake and it is heartening to see such a coalition build against them, however it is clear that this mistake could have been avoided had there been greater citizen engagement with the tax process in the first place. This would have meant that the errors in the plans could have been rooted out sooner rather than on the front pages of newspapers.

In short, fundamental issues still exist. Until we grapple with these key problems we will fail to build a modern system fit for the digital age.

The points raised in this report are as important now as they were when the Group drafted it one year ago, and it is vital lessons are taken from it.

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1. Background

For the majority of taxpayers, income tax is collected through Pay As You Earn (PAYE). Employers deduct tax from their employees' pay according to PAYE codes which reflect the employees' personal and financial circumstances. The amount withheld by employers and passed on to HM Revenue and Customs (HMRC), on a monthly or quarterly basis, is designed to exactly match the annual tax liability for each employee.

PAYE has gone largely unreformed since its introduction almost 70 years ago by the wartime chancellor Sir Kingsley Wood, and today the system faces a number of challenges. Further, on April 6th 2013, the most significant change to PAYE since its inception in 1944 came into effect. Real Time Information (RTI) will require all employers to report to HMRC their employees' income "on or before" the date they are paid, as opposed to only once a year. HMRC believe that this will improve their ability to keep track of individuals' income and reduce errors. RTI will also pave the way for the introduction of the Universal Credit (UC) in October 2013. This single monthly payment brings together a number of working age benefits and will vary according to the claimant's earnings to ensure work always pays.

Both the Federation of Small Businesses (FSB) and the Institute of Chartered Accounts in England and Wales (ICAEW) have consistently raised concerns about the practicality of small firms being asked to report data so regularly to HMRC, and the impact of the additional burdens this will create. HMRC has responded by allowing employers with less than 50 staff to report payroll information monthly, rather than in "real time", until October 2013 to allow them more time to adjust. Both the FSB and the ICAEW have called for these changes to be made permanent, but since small firms account for nearly half of all private sector employment, this would be a significant departure from HMRC's original vision for RTI.

The purpose of this report is to examine how well these changes to the way PAYE operates will address the structural challenges, identified above, which the system faces. One of the welcome impacts of the introduction of RTI has been to focus much more attention upon the way in which Government administers tax than was the case when the All-Party Parliamentary Taxation Group was formed in 2006. Whilst it is not a subject that has historically received the attention it deserves, in times of economic austerity it is vitally important that Government can collect the revenues it needs, and that it is seen to be doing so in a way that is both efficient and fair.

2. PAYE and RTI Explained

PAYE is the withholding system used by employers to deduct income tax and national insurance contributions (NICs). It was introduced in 1944 to help the Treasury with the financial strains of the Second World War and its foundations have remained largely unchanged until now. In 2010-11, PAYE accounted for 55% of the Government's revenue, collecting £132bn in income tax and £97bn in NICs making it the Government's largest revenue single source of revenue by far.

The PAYE system is operated by employers and consists of five major procedures:

- Calculation of deductions—including determination of what is taxable;
- Determination and reporting of benefits-in-kind;
- Payment of PAYE to HMRC (19th or 22nd day of the following month or quarterly in some cases);
- Reporting when an employee leaves and joins (P45 and P46 forms); and
- End-of-year reporting (P14 and P35 forms to HMRC, and P60 form to employees no later than 6 weeks after the end of the tax year).

In order to calculate deductions, employers require a tax code for each employee indicating an employee's tax-free pay. Tax codes are calculated by HMRC and are unique to each employee taking into account four components: income allowances, employee benefits, expenses, and deductions.

Following the introduction of RTI employers no longer have to submit the annual P14 and P35 returns to HMRC, which currently serve to inform the Department of the pay made to each employee. Nor will they have to submit P45 or P46 forms when an employee leaves or joins. Instead, this information will be submitted as part of each payroll, known as a Full Payment Submission (FPS). Employers will also have to submit an Employer Payment Summary (EPS) to notify HMRC when they have made statutory payments, such as sick pay, to their staff to ensure the Department correctly calculates the money the employer is expected to pass on. Larger firms, with over 250 employees, will also have to submit an Employer's Alignment Submission when they begin reporting in real time to align their records with HMRC's.

3. Structural challenges for PAYE

Even before the introduction of RTI, PAYE faced a number of challenges. The major changes to the way we work in evidence across the developed world are making it more difficult for HMRC to keep track of what every taxpayer owes. The current system fails to support targeted benefits and credits, and places burdens on business, particularly on small employers to a disproportionate degree. Finally, the system has left taxpayers largely disengaged from their tax affairs, which means that errors go unnoticed and accumulate within the tax system.

Changes to the way we work

The world of work looks very different today than it did when PAYE was introduced. The system is predicated on HMRC knowing when an employee starts working for their employer; when the employee stops working for them; and the employee's total pay to date. In 1944, the labour market was more rigid than it is today, and many employees had one job for life, which helped ensure that the tax code system worked effectively.

But today, the labour market is significantly more complex, and the modern worker is more flexible and mobile. For example:

- Higher numbers of taxpayers hold multiple sources of income—the number of second jobs increased by 68% between 1984 and 2001;
- Casual employment is more common;
- Average job time is shorter—20% last less than one year and 5% less than 3 months; and
- Taxpayers move jobs more frequently—13 million people moved jobs in 2006.

As the APPTG noted in 2012, PAYE often finds itself left behind. As a result, for the tax year 2010-11, there were under- or overpayments for 5.1 million people, so that approximately 1 in 6 of the UK's working population received refunds or were required to make additional payments. Unlike in other countries, in the UK such reconciliations are usually unexpected by taxpayers and can create a range of negative financial and emotional consequences, especially in cases where a bill for underpayment is too large for the affected taxpayer's personal or household budget.

Supporting work benefits

The introduction of Working Tax Credits (WTC) by the previous Government highlighted the weakness of a system like PAYE—where employers rather than taxpayers are responsible to collating and sharing information with the Revenue authorities—to distribute the kinds of personal tax incentives which are the norm in many countries. Simply put, where individual claimants have little role in the process and are not accustomed to taking responsibility for their

tax affairs, Government struggles to gain accurate information about their entitlement for such benefits without imposing additional reporting requirements.

WTC were introduced in 2003 to supplement the incomes of those in low paid jobs. The expectation at the time of their introduction was that employers, alongside HMRC, would administer WTC, which were paid as part of the claimant's wage. The National Audit Office estimated that in the first three years of operation, £6bn of overpayments were made to some of the poorest households in the UK, which subsequently had to be reclaimed. In response, from 2006 HMRC took on responsibility from employers for making these payments. To ensure the Department had the correct information in order to be able to calculate WTC correctly, claimants are now required to submit annual renewal or declaration returns detailing their eligibility and income for the previous year.

Burdens on business

Unless they have complex financial circumstances, HMRC frees most employees from having to engage with their tax affairs. Instead, it is their employers who take on this burden. The cost of administering PAYE falls disproportionately on small employers because they cannot take advantage of economies of scale, causing a harmful competitive distortion between small and large firms. The current system of PAYE tilts the playing field against small businesses and discourages them from taking on new employees. In 2006, KPMG noted as part of a project for HMRC that 86% of the administrative burden of PAYE falls upon businesses with less than 50 staff.

Taxpayer disengagement

PAYE is designed to minimize the role of taxpayers. Reductions in compliance costs for taxpayers are desirable, but they have the problematic effect of disengaging taxpayers from the administrative structures and logic underpinning the tax system. The ICAEW commented in 2012 that 70 years of PAYE had created an 'ostrich approach', where taxpayers assume they do not have any responsibilities in the operation of the PAYE system. This problem can lead directly to the miscalculation of PAYE in cases where taxpayers have not provided HMRC with all the information they need to calculate their tax code, or when a taxpayer fails to spot an error made by their employer or HMRC and this error's impact accumulates over time.

Further, as the APPTG noted in 2012, the taxpayer does not receive any statement from HMRC showing the total amount of tax they have paid for the year. An employee only receives a P60 form from their employer after the end of the tax year detailing their pay and PAYE deductions for that specific employment income. The citizen is not informed by HMRC at any point of the amount they contribute to the State.

4. Impact of RTI reforms

It is difficult to predict whether businesses will in practice be able to provide HMRC with the accurate and timely reports on employee income as envisaged under RTI. Of course, at a conceptual level, if such information is more readily available, the Department should be able to calculate PAYE codes more accurately. It is certainly not sustainable in a modern tax system that these codes are based upon data that is a year old. In addition, and again conceptually, with more timely information, Government will be in a position to implement a UC to low-income workers, to ensure that work always pays. However, as illustrated by the previous Government's experience of WTC, the detrimental impact of information not flowing as required from the claimant to HMRC is extensive. Under the new system, parallel reporting from the claimant to the Government will still be required. Finally, while the reduced reporting obligations announced by HMRC for employers with less than 50 staff will reduce some of the burdens for smaller businesses, if these concessions are made permanent, their impact will be undermine the gains from the reforms.

These issues aside, however, it is already clear that the introduction of RTI will do little to address the more fundamental challenges PAYE faces:

- Small businesses will continue be burdened by the cost of administrating the system, disincentivising them from employing staff;
- Government is restricted in the kinds of incentives it can provide taxpayers with, since there is no channel through which information can effectively flow between the two; and
- Perhaps most worryingly, taxpayers will continue to be largely disengaged from the system, which means that errors will continue to go unnoticed and that the citizen remains at best a bystander in the process of tax administration.

5. Conclusion

The introduction of RTI in the UK must be understood in the context of the challenges PAYE is facing and the political imperative of delivering a benefits system that rewards work and is free from some of the perverse incentives currently in play. If businesses prove able to provide HMRC with the accurate and timely reports on employee income the Department requires, then RTI may prove to be a sensible first step towards putting the UK's tax administration on a sounder footing. The high rates of error in the system and the cost to HMRC of reconciling them are not sustainable in the long-term. However, the major structural challenges associated with PAYE remain in place, making RTI at best an interim solution before the UK's tax system is reformed more fundamentally.