



TAXREP 63/15 (ICAEW REPRESENTATION 176/15)

ALIGNMENT OF INCOME TAX AND NATIONAL INSURANCE

ICAEW welcomes the opportunity to submit evidence for the review *Alignment of income tax and national insurance* published by the Office of Tax Simplification on [21 July 2015](#) and supplemented by OTS questions on [19 October 2015](#).

This response of 23 December 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax and NIC systems.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 4, 9 and 30 November we attended meetings with the Office of Tax Simplification (the first meeting jointly with CIOT and the third meeting as a member of the RTI Stakeholder Taskforce) in which we were able to put forward some key comments and discuss aspects of the review.

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ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

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SUMMARY OF COMMENTS

1. In broad terms, taking into account the history of alignment initiatives, and the remit of the Office of Tax Simplification (OTS) to simplify the tax system and lighten the burden on taxpayers, we have concluded on balance that the only sensible approach to alignment is to focus on those matters that would provide improvements and efficiencies without major upheaval for taxpayers and HMRC, since neither has spare resources to devote to 'nice-to-have' matters rather than clear necessities.
2. It was widely felt by members that the only reason to change would be tangible simplification and consequent cost reductions for all concerned, not alignment for the sake of alignment. Making the national insurance contributions (NIC) system more comprehensible for taxpayers at the cost of extra work for employers and HMRC, both during the period of change and on an ongoing basis, would seem less than a worthy goal. It is doubtful that any taxpayer fully understands how the NIC on a payslip translate into benefit entitlements, but it is equally difficult to see how imposing a different system of liability and collection might add to taxpayer knowledge or interest and at the same time make the system work better.
3. Some members believe full alignment of PAYE and NIC should be pursued, while others think that many of the complexities that were once a problem are now, since almost every employer uses software, handled by a computer and no longer worthy of attention.
4. That said, all would recommend some clear simplifications:
 - The alignment of the definition of earnings should be pursued, but not to the point that it creates more confusion than it alleviates. The tax definitions are better understood, so they should form the basis of a harmonised set of definitions.
 - The treatment of employment expenses should be aligned. It is anomalous that an employee may make a retrospective claim for a deduction (or, in future, exemption) for tax purposes, but the decision about how much is subject to NIC must be made by the employer at the time of payment. If the figure can only be established accurately when all facts are available, retrospective adjustments and refund claims must be allowed for both tax and NIC.
 - The P11D process was necessary because PAYE cannot be withheld from most benefits in kind in real time. The Class 1A process works well because it relies on the data collected annually for the P11D. There seems little justification for items of remuneration to be dealt with through the P11D for tax purposes but through the payroll for NICs purposes. Real simplification would be achieved if there was a simple rule: if an item is taxable and NICable but does not involve cash being paid to an employee, the tax and NICs should both be collected via the P11D and P11D(b). If ministers are concerned that employers would change behaviour to provide more benefits in order to avoid the associated 2% employee NIC liability, the Class 1A NIC rate could be raised marginally to compensate.
 - The collection, enforcement and appeal processes should be fully aligned.
5. Any meaningful reform of employee contributions to align them more closely with PAYE would inevitably require a divorce between employer and employee contributions. This would generate two new sets of NIC rules to replace the current single system, with differences that add to the complexity of the system. A fundamental reform of the social security system might provide a reason for a root and branch reform of NIC in this way, but it would not be simpler or more efficient than the current regime.
6. Operation of tax and NIC differs hugely in cross-border contexts. Alignment might be achieved if the statutory residence test was adopted for NIC as well as income tax, but it must also be recognised that the residence and presence rules differ in their origins and purpose: tax is merely about raising revenue from year to year, but NIC rules need to establish longer-term links between a contributor and the NIC system so as to protect those who are entitled to

social security cover under the UK regime. NIC rules also require a decision to be made about residence status at the time of payment, rather than after the end of the year when aggregate day counts can be established, so the statutory residence test (SRT) may not be appropriate to NIC liability.

7. The domicile rules are another area of difference, but in this case it would seem to make sense to bring the tax rules closer to the NIC rules if any change is to be made with a view to simplification. The remittance basis is an impediment to alignment. It is arguable that any worker who becomes UK resident should pay UK NIC, and income tax, on the same income, except where a tax or social security treaty decrees otherwise. Overseas workday relief should apply, or not apply, to income in the same way for both purposes.

RESPONSES TO SPECIFIC OTS QUESTIONS PUBLISHED ON 19 OCTOBER 2015

8. We address briefly below the key questions posed by the OTS.

Q1: Background and general thoughts

9. The ICAEW includes 144,000 members, around half in business and half in practice, acting as employers or their agents across all types and sizes of organisation.
10. The 'big picture' idea of aligning tax and NIC is very popular among the members who contributed to our response, but opinions differ widely on how far any alignment can and should go. Some members support minimal change, dealing with just quick wins without fundamental change, while others would support total alignment of Class 1 NIC with PAYE, with the many detailed reforms that it would entail, and imposing extra liabilities on the self-employed so that they make the same contributions as employees and their employers, since their benefit entitlements from April 2016 will become almost identical.

Q2: The present structure of IT and NIC

11. We do not believe that the present structure of either income tax (IT) or NIC is well understood by most taxpayers, but it is not clear that any alignment exercise would change this picture. Taxpayers would still broadly understand that paying NIC earns a benefit entitlement. However major or minor any reform might be, it is doubtful that taxpayer understanding or interest would be a major beneficiary.
12. We should not lose sight of the fact that the present regime generally works well in terms of its mechanics (we make no comment about the political aspects). Employer guidance is fairly clear, and employers and advisers generally do not struggle with the differences between tax and NIC rules. It is unclear why this is thought to be a major problem that requires government action. The key to improvement is stability and gradual, logical adjustments rather than full alignment. Any major change to the NIC rules would take several years (or more) to bed in and inevitably generate more errors than the current rules.
13. We do not believe that the current differences between PAYE and NIC rules cause material administrative costs or impact taxpayer behaviour: employers generally comply with the rules other than when they make genuine mistakes.

Q3: Distinctions between IT & NICs – definitions

14. The tables in the employer guidance (CWG2, CWG5) provide fairly clear guidance about whether a payment must be subjected to PAYE, P11D reporting, Class 1 or Class 1A NICs. As noted above, we believe there is a good case, driven by simplification and efficiency gains, for settling on consistency, ie, tax and NIC through payroll or tax and NIC through P11D/P11D(b), but not some kind of hybrid treatment. It is a puzzle to employers and many agents why, for example, pecuniary liability payments must be payrolled for NIC but taxed via

a P11D and coding adjustment, while employer contracts are dealt with through P11D and P11D(b), when the same economic benefit is being provided to the employee at the same time. Similarly, while reward vouchers are clear P11D items, they must be processed through payroll for NIC purposes. This presumably stems from their past use in NIC avoidance schemes, but the cash flow gain to the Exchequer must be infinitesimal by comparison with the work needed by employers to use two processes rather than one.

15. There is an argument for removing the Categorisation of Earners Regulations 1978 (albeit while keeping the deemed employment status of agency workers for both PAYE and NIC) as an unnecessary complication, but all of those rules were put there for a good reason (eg, to protect the state pension entitlements of clergymen, or simplify the administration of payments to electoral officers), so we would recommend a full review of each element for its efficacy and continued relevance before it is changed.
16. At the same time, there is an argument for a wholesale reform of the NIC treatment of self-employed workers. From April 2016, the only real difference between the entitlements of employed and self-employed workers will lie in contributory jobseekers allowance (JSA), which is an almost immaterial component of the NI regime. It is unclear why the contribution liabilities of employed and self-employed contributor remain so divergent.
17. The proposed merger of Class 2 and Class 4 NICs may be a step towards simplification of the liability and collection rules, but will not improve equity between classes of contributor. It is tempting to think that many difficulties could be removed if the liabilities of employed and self-employed workers were aligned, but for difficult cases the Categorisation Regulations would still be needed so as to identify who was responsible for the payment of contributions where there was no obvious employer.

Q4: Administration

18. Cumulation and aggregation would make NIC look and feel like PAYE, although there would still have to be a separate line on the payslip because of the exclusion of under-16s, state pensioners and exempt foreigners.
19. Operating NIC like PAYE is attractive in terms of making the charge look simpler, but there would be many winners and losers, the latter including a lot of low-pay workers with multiple part-time jobs.
20. We would have grave concerns about the ability of a slimmed-down HMRC to administer a system that would involve a doubled coding run, and an annual reconciliation of NIC in addition to the annual reconciliation of income tax on the P800, all needed more timeously for NIC in case benefit claims are made.
21. There would need to be a NIC code, but it would necessarily differ from the PAYE code, given that (a) thresholds are not and cannot feasibly be aligned (without creating a lot of losers and without a reversal of government policy on personal allowances), (b) tax reliefs for pensions, payroll giving and sideways trade losses would have to be treated differently, and (c) underpaid tax and NICs rolled forward would be different.
22. Cumulation and aggregation would require a divorce between employer and employee NIC, creating a second and different set of rules for employers and HMRC compliance staff to learn.
23. None of this remotely resembles simplification or efficiency.

Q5: Employed v self-employed

24. See comments above.

Q6: Employers' NIC

25. Employers' NIC work well. Class 1A works well for P11D earnings, and Class 1B is fairly straightforward. It will become even more so once the P9D-P11D distinction disappears in April 2016.

26. Alignment of the definition of earnings should not adversely affect the operation of employer NIC, but divorcing employer and employee NICs to enable aggregation and cumulation would create extra work. Great thought would have to be put into how employment was not to be discouraged if the employer's secondary threshold was removed. There is a superficial attraction to applying a flat-rate payroll tax to replace secondary NICs, but it would then become a tax on low-pay jobs, even with an enhanced employment allowance. There would be a danger of creating disparities between large and small businesses if the secondary threshold was removed in favour of a lower flat-rate payroll tax with no NIC-free band per employee.

27. Employees generally probably have no concept of employer NIC, as they are not generally disclosed on payslips.

Q7: General administration

28. HMRC does not generally distinguish between tax and NIC except in relation to well-known differences, such as the processing of pecuniary liability payments through payroll. This also occurs at the policy level: for example, when the tax exemption for bonuses of up to £3,600 for employees of companies controlled by employee ownership trusts was introduced in 2013, no matching NIC exemption was included in the legislation, indicating that nobody thinks about NIC differently from income tax.

29. Alignment of the definition of earnings might make the administration of the PAYE and NIC system marginally easier, but since all the calculations are performed by computer once the data has been input, it is doubtful if any such savings would be material.

Q8: The contributory principle

30. Some see the contributory principle as illusory, others as a valuable lever to allow governments to collect more income tax without the populace complaining. People generally still believe that paying NIC is worthwhile because they believe that they will receive a non-means-tested state pension in due course, and will qualify for non-means-tested JSA if they become unemployed, or non-mean-tested ESA if sick and unable to claim SSP.

31. It is impossible to see, let alone quantify, the contributory principle affecting in any detail the decisions on alignment. It is entirely possible to devise a link between annual NIC paid and contributory benefit entitlement, at least for long-term benefits, but while it would perhaps be different, it is hard to see how this would be materially simpler or more efficient than the current regime.

Q9: International aspects

32. The cross-border implications of alignment were touched on above. The US system brings alignment by charging everyone at the same rate, with the self-employed paying their own employer contributions, and with employers accounting through payroll. The Dutch system keeps employer and employee contributions apart by asking each to pay for different benefits. The Danes fund social security from the tax system, with small flat-rate contributions as, in effect, a membership ticket. The Germans allow many people to opt out of most social

security cover and make private provision instead, but cover is compulsory (except for the self-employed) and employers pay roughly half of all costs. There is no particular model that stands out as better or worse than the UK model.

Q10: First choice alignments

33. See the summary comments above for the main areas in which we think that material improvements in simplification and burden-lifting can be made.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via <http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax>).