OTS report on the closer alignment of income tax and national insurance: a further review

The OTS have now published an updated report on the closer alignment of income tax and National Insurance Contributions (NIC).The report, published on 14 November 2016, builds upon the findings of their previous review and looks in greater detail at the two areas stated in the Terms of Reference (Phase 2), which was published in May 2016. Specifically, these areas are:

- A review of the impact of moving employee NICs to an annual, cumulative and aggregated basis (ACA) similar to the collection of income tax under the PAYE system. NICs are currently calculated on a pay period basis; and
- A review focused on the reform of employer NICs to a payroll based charge.

The report sets out a five year timetable for implementation and notes that this timeframe could align with the implementation of Making Tax Digital.

ACA basis for Employees' NIC

Currently if one individual has more than one job, each job is treated separately for employees' NIC purposes and employees' NIC is calculated differently from PAYE income tax. The ACA basis of calculating NIC would be similar to the way in which income tax due via PAYE is currently calculated. In order to make this change, HMRC would issue a NIC code to employers and employees, similar to PAYE codes.

The OTS report estimates that under an ACA approach 5.5 million employees would find themselves paying more NIC (with the average being an extra £242) and 7.6 million paying less NIC (average being £169). Based on their estimates, the OTS believes that this measure would be broadly revenue neutral. The proposed approach is intended to remove the distortions in the current system whereby individuals can be paid the same total salary but be liable to pay different amounts of NIC depending on how they receive the salary. A table from the OTS report brings out this point:

Income for the year 2015 to 2016	IT	NICs	Total Tax
£15,000 received from one employer spread equally over 12 months	£880	£832	£1712
£15,000 received from one employer in one month with no income the rest of the year	£880	£572	£1452
£5,000 received from each of 3 employers, spread equally over 12 months	£880	£0	£880

Payroll based charge for Employers' NIC

Currently employers' Class 1 NIC is calculated at 13.8% of an employee's weekly or monthly pay over a secondary threshold of £156 per week/£676 per month. The proposed approach is to move to a flat percentage of the total payroll costs, which would include the cash value of benefits-in-kind, thereby incorporating and effectively replacing Class 1A NIC. The OTS report explores eight different options as to how this could operate.

These are as follows:

1) Flat rate of payroll total, removal of secondary threshold (ST) and remain revenue neutral:
   a) 10% rate, no ST, no employment allowance (EA);
   b) 10.4% rate, no ST, EA of £3,000;
   c) 11.8% rate, no ST, EA of £46,500;
   d) 13.8% rate, no ST, EA of £332,200.
2) Replace the ST with an annual cumulative employee allowance;
3) Link to a specified percentage of employee primary NIC;
4) Retain existing system; or
5) Replace the ST with a full-time equivalent employee allowance.

Whilst the approach under 1a is not ruled out in the report, it notes that by removing thresholds and allowances there could be a materially adverse effect on smaller businesses. The report suggests that Option 2, 'Replace the ST with an annual cumulative employee allowance', may be the best option.

Under this approach, the employer would deduct a £3,000 employment allowance per employee from their total payroll costs before applying the 13.8% charge for employers' Class 1 NIC.

KPMG's views

We believe that the proposals are an important step forward in shining a light on the way in which employees' NIC might be more clearly aligned to income tax, and how employers' NIC might be simplified. We have always been supportive of this as we believe that it will ultimately reduce costs for employers, individuals and HMRC. We discuss our views on the two main issues below:

ACA basis of Employees' NIC

The move towards an ACA basis is welcomed, however as noted above, this approach creates 'winners' and 'losers'. The OTS has identified that many of the potential 'losers' under this reform are low paid individuals with multiple jobs who will pay more NIC than they do under the current rules. This is notwithstanding that some will gain greater entitlement to contributory benefits such as the state retirement pension, or receive more Universal Credit due to the fall in their net income.

In light of this report we would encourage the Government to compensate those on low pay who will now be liable to pay more NIC. This could be done by increasing the primary threshold at which employees' NIC becomes payable and would also be consistent with the increases in recent years in the income tax personal allowance.

If the Government ensures that individuals' entitlement to benefits will not be adversely affected by this alignment, and the 'losers' are protected by raising the primary threshold, then we believe that these measures can further the process of aligning income tax and NIC in a fair and equitable manner.

The report considers the effect of moving entitlement under the benefits system from a build-up based in many cases on qualifying weeks, to an annual basis concurrent with a move to an ACA basis for employees' NIC. However, we think that provided the lower paid are protected there is a case for leaving entitlement under the benefits system as is. This would allow real progress to be made in simplifying the collection of employees' NIC without becoming bogged down in a debate on the shape of the benefits system. (A change to the basis of collection of employees' NIC should not of itself impact on the availability of data required to record people's benefit entitlement under the current system.)

Payroll based charge for Employers' NIC

The introduction of a payroll based charge for employers' NIC would be a welcome simplification in our view. However, careful consideration would be required on future interaction with the Apprenticeship Levy. In addition, further work will be needed on its effect on certain industry sectors and in relation to the size of employers (particularly smaller employers). That said, we believe that distinguishing employers' NIC from employees' NIC is the right approach, effectively regarding it as a payroll levy in future. Employers' NIC does not provide any employee benefit entitlement and, as such, an aggregate levy seems more appropriate and clearly more transparent. In due course, we believe that the Government should look further at employers' NIC, and specifically the 'unlevel' playing field as regards employment and self-employment - consideration should be given to whether an overall change in direction is required on what is effectively a 'tax on jobs' at present.

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