

July 2015

## Alignment of Income Tax and National Insurance

### Introduction

The Office of Tax Simplification (OTS) has agreed with the government to undertake a study into the closer alignment of income tax and National Insurance contributions. The aim is to build on the OTS's earlier work and recommendations in this area, to understand the different stages of improving the alignment of the taxes.

The OTS will publish a final report ahead of Budget 2016. It may publish an interim report and/or calls for evidence during its work.

### Terms of Reference

The main aim of the project is to explore more fully the steps that would need to be taken to achieve closer alignment of income tax and National Insurance contributions, and the costs, benefits and impacts of each of those steps.

The report will consider the evidence already available, including previous OTS work, and undertake further research with stakeholders and taxpayers. The OTS will consider in particular:

1. The case for change, including the distortions, burdens and costs associated with the current system.
2. The changes that could be introduced to bring the two systems closer together in relation to the taxation of earned income (for employers and employees) and the self-employed.
3. The costs, benefits and impacts of each step.
4. All forms of NIC charge, including employers' NICs
5. How any changes would fit with wider government policy/objectives, including:
  - The system of determining entitlement to contributory benefits;
  - Exchequer costs
  - Burdens for business

The review will consider the base of the systems but will not consider the extension of NICs to non-employment income (such as property, dividends and pensions).

In carrying out its work and framing its recommendations, the OTS should have regard to:

- The effect on taxpayer and business understanding of the system
- The likely effect on compliance burdens

- The impact on any distortions to current taxpayer behaviour caused by the current system
- Avoidance risks
- The principles and design of HMRC's Making Tax Easier reforms, including digital tax accounts, integrated reporting and payment
- HMRC operational impacts
- Likely revenue implications, both in terms of exchequer impact and the impact on different types of taxpayers
- Administrative costs for government (including the administration of the contributory benefit system)
- Fairness and consistency of treatment of taxpayers

## Resources

The OTS will take on staff to undertake the fieldwork for this project and will also need appropriate expertise to assist with work around impacts of potential changes. The OTS may, in association with HMRC, commission external research to assist with any aspects of the work.

## Background: income tax and NICs & previous OTS work

The UK imposes two levies on income: income tax and national insurance contributions (NICs). Although superficially both tax the same thing, in practice there are wide differences, for example:

- Income tax taxes (in principle) all income; NICs are levied on employment earnings and self-employment profits, and not on other forms of income such as savings, pensions or investments.
- The basis of calculation for employment income are different between income tax (on an annual basis across all income sources) and NIC (on an earnings basis per employment and per pay period for employed earners).
- The legal definitions of earnings are different for income tax and employee NICs, with a number of items relating to employment, including benefits in kind and expenses, being treated differently between the two codes.
- Although both income tax and NICs are collected under PAYE, income tax is collected on a cumulative basis; NICs on a pay period basis.
- NICs continue to have a contributory link, although some commentators have suggested that this is much weaker than in the past.
- The (annual) starting points for the two levies, once aligned, are now considerably different.
- The self-employed pay NICs at a lower rate than employees and under the contributory system, have slightly reduced benefit entitlement, although the planned abolition of Class 2 NICs would mean that the self-employed will pay a single class of NICs like employees.

Employee and employer NICs are largely aligned. Cash and cash-like elements (such as shares and other readily convertible assets) of both are largely aligned and collected through PAYE on a pay period basis. Other non-cash elements (benefits in kind) are charged to employer NICs only and collected at the end of the year in a separate payment, although from 2016 some non-cash elements may be collected voluntarily through the payroll in line with previous OTS recommendations.

In the OTS Small Business Review, differences in the rules and procedures between the income tax and NICs systems were found to be the second highest source of complexity for small businesses.

The report identified that maintaining two separate systems led to a number of anomalies, helping to distort business behaviour. The OTS recommended bringing the two systems close together and, importantly, set out a number of stages that could be taken to implement this whilst stopping short of a full merger. Our point was that each of the stages would yield simplification dividends.<sup>1</sup>

Following the OTS Small Business Review<sup>2</sup>, in 2011 the government set up a number of stakeholder groups and commissioned external research into attitudes of small employers, and a paper was published summarising the results. It was decided to wait for progress on other changes to the tax system that employers were implementing (for example on Real Time Information and the Scottish Rate of Income Tax) before consulting further on aligning the operation of income tax and NIC.

The OTS's subsequent UK Competitiveness Review and Employment Status report both returned to the issue of IT/NIC alignment. Both reports reiterated the difficulties caused by the differing systems; closer alignment was seen as a way of improving competitiveness and as the main indirect way of 'solving' employment status problems. The impact of the employers' NICs was seen a major issue in both cases.

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<sup>1</sup> The integration of Class 2 into Class 4 was one of the steps we recommended.

<sup>2</sup> Integration of the two systems has been suggested in a number of independent reports, including the IFS: Integrating income tax and national insurance: an interim report, and the Mirrlees Report chapter 5: Tax by Design.