

## **REGULATORY IMPACT ASSESSMENT (RIA)**

### **The abolition of payment of Working Tax Credit via employers**

1. The Government announced in Budget 2004 that the payment of Working Tax Credit (WTC) via employers (PVE) would in due course be replaced by direct payment, subject to consultation on the detail of implementation.
2. Following consultation with employer representatives and other stakeholders, the Government announced in Budget 2005 that PVE would be phased out between November 2005 and April 2006.

### **Purpose and intended effect of the measures**

#### ***The policy objectives***

3. The policy objective underlying the abolition of PVE is to reduce the regulatory burden on business.
4. At the same time the Government wants to ensure that
  - claimants are well prepared for the phasing out of PVE and the switch to direct payment;
  - any transitional compliance costs to employers are as low as possible; and
  - the switch to direct payment by Her Majesty's Revenue & Customs (HMRC) does not weaken the visible link between work and receipt of WTC that PVE currently provides.

#### ***Background and introduction***

5. WTC and Child Tax Credit (CTC), introduced in April 2003 and assessed and administered by the Inland Revenue (now HMRC), are part of a series of reforms aimed at making work pay and relieving child poverty. They build on the framework established in the former Working Families' Tax Credit (WFTC), Disabled Person's Tax Credit (DPTC) and Children's Tax Credit. WTC is an income-related payment to low-income workers, whether or not they have children. It is made up of various elements, including a childcare element that provides help with up to 70% of approved child care costs. CTC, also income-related, is a payment to people with responsibility for at least one child or qualifying young person, whether or not anyone in the household is working.

6. In April 2000 PVE was introduced for WFTC and DPTC to reinforce – and to demonstrate – the link between receipt of tax credit and the rewards of work. Since April 2003, when these tax credits were abolished, employers have paid WTC (apart from the child care element) to employees through the payroll. HMRC pays CTC and the child care element of WTC direct to claimants, and all elements of WTC to self-employed workers. Once PVE has been phased out, HMRC will make all payments of both tax credits direct to claimants.

7. The current PVE scheme is broadly similar to the original arrangements. HMRC assesses claims and makes awards of both tax credits. If the claimant is entitled to WTC and is an employee, the Department sends the employer a start notice telling him when to start paying WTC with wages, and how much to pay (expressed as a daily rate). Employers have at least 42 days to adjust their payrolls before starting to make tax credit payments and must then continue to make the payments on each pay day until the employee leaves or dies, or HMRC sends the employer a stop notice. If the daily rate needs to be amended (for example, because the claimant has reported a change of circumstances), HMRC sends the employer an amendment notice showing the revised daily rate of WTC. Again, the employer has 42 days to action the notice.

8. Employers must show the tax credit paid as a separate item on the employee's payslip.

9. Employers pay WTC out of the PAYE tax, student loan deductions, National Insurance contributions and subcontractor deductions that they are due to pay to HMRC each month or quarter. If these are not enough to cover the amount of tax credit they have been told to pay, they can apply to HMRC for advance funding to make up the difference. Employers have to account on their end-of-year return (form P35) for the tax credit paid and the funding received and they must keep all payroll records and tax credit forms for three years after the end of the tax year to which they relate.

### ***The risk(s)/harm being addressed***

10. While much has been done to minimise compliance costs through the consultation process, PVE inevitably imposes some additional costs on employers.

11. The RIA for the original PVE scheme under the old tax credits, published in December 1999, estimated non-recurring compliance costs to business of about £40 million and recurring costs of around £100 million a year. The RIA for WTC and CTC, published in July 2002, predicted that employer costs would be reduced by £11 million a year as a result of some key improvements which addressed employer concerns about the original scheme.

12. From the outset employer representatives and employers generally were opposed to PVE, believing that employers should not be expected to take on this administrative role in carrying out Government policy. However,

research carried out by BMRB International and the Policy Studies Institute as part of the evaluation of WFTC in 2002, and published in 2003, showed that the system was less burdensome than predicted. The majority of employers surveyed found PVE relatively easy to operate.

13. When the new tax credits system was introduced in April 2003 various Inland Revenue computer problems caused a great deal of extra work for employers. Although most of these problems were resolved within a few months, there have been recurring glitches, and other features of the system have been more burdensome for employers than had been anticipated. For example, the volume of amendment notices being sent to employers has been far higher than had been expected.

14. As part of its drive to reduce regulatory burdens the Government therefore decided that the balance of advantage had moved in favour of direct payment of WTC.

## **Options**

### Option 1 – do nothing, that is, retain PVE

15. Under this option employers would continue to pay WTC through the payroll, incurring annual compliance costs estimated (in the 2002 RIA) at around £90 million.

16. From the Government's perspective, PVE has been an undoubted success. It has played a central role in helping to deliver the Government's key policy of making work pay and in reducing the stigma of claiming in-work support. However, in the context of the overall aim of reducing burdens on business wherever possible, the do nothing option was rejected, subject to appropriate transitional arrangements.

### Option 2 – abolish PVE with appropriate transitional arrangements

17. The main advantage of this option is that there would be a substantial reduction in compliance costs to business. In addition, abolishing PVE would free up HMRC IT resources which could be used to enhance other parts of the tax credits system. This option was adopted.

18. At the same time the Government is concerned that the transition should proceed as smoothly as possible for both claimants and employers; and that the change should not negate or reverse the progress made so far in demonstrating that work pays and in reducing the stigma of claiming in-work support.

19. To ensure that claimants understand the change, and to meet the policy objectives set out in paragraphs 3 and 4 above, the Government decided on a threefold strategy for managing the transition:

- HMRC would send targeted mailshots to employers and employees explaining how the change will affect them;

- WTC would be clearly identified on bank, building society and Post Office account statements as “Working Tax Credit”, rather than being included in the generic “tax credits” descriptor currently used; and
- employers would write to their PVE employees direct to alert them to the change.

All three components of the strategy would play a vital role in helping to ensure a smooth transition.

20. Consideration was given to whether it should be compulsory for employers to write to their PVE employees about the phasing out of PVE. Under the non-regulatory option employers would, if they wished, write to their employees about the change. The alternative was to make the employer letter a regulatory requirement.

21. The overriding argument against the non-regulatory option was that, faced with a choice, employers would be likely to choose not to send the letter to their employees. Ministers, in line with members of the Social Security Advisory Committee, felt that it was very important for employees to be alerted to the change by both HMRC and their employer. They therefore decided that the best way of ensuring that all PVE employees received a written communication from their employer was to make the employer letter compulsory. Annex B gives more detail on the transitional options considered.

### **Business sectors affected**

22. PVE affects large, medium and small businesses in all sectors. Under the PVE scheme any business employing one or more workers, and operating a PAYE scheme, could be notified by HMRC to operate PVE. Even those who do not have any employees entitled to WTC must be reasonably familiar with the scheme and be ready to operate it if asked by HMRC to do so. So all business sectors stand to gain from the abolition of PVE.

23. We estimate that around 120,000 employers will be operating PVE in the run-up to November 2005 when the phasing out begins, so this is the number that will be required to send targeted letters to their PVE employees at that time.

### **Costs and benefits to employers**

#### *Costs*

24. There are no significant long-term costs to employers from abolishing PVE. Once PVE is abolished, the only remaining tax credit obligations on employers will be to

- retain tax credit records after the end of the tax year to which they relate (the cost of which we estimate will be negligible); and

- answer earnings enquiries or requests for other information by HMRC in relation to their employees who have claimed tax credits. The work involved in this for employers will be minimal and the cost negligible, because HMRC would ask employers for information only if they could not obtain it from other sources or had reason to suspect that a claimant was not stating his true earnings or working hours.

Some employers who pay salary (and therefore WTC) in arrears, and who may pay March WTC in the 2006-07 tax year, will incur the cost of a phone call to notify HMRC of this. HMRC will then arrange to reimburse these employers, as they will not be able to account for the payments on their 2006-07 tax returns. Because of the steps HMRC are taking to issue stop notices to all employers well before the end of the tax year, the number of employers who will incur these costs is expected to be very small.

25. In the short term, there will be one-off compliance costs in 2005-06 associated with the targeted letter that employers will have to send to their PVE employees to advise them of the change in payment method. We estimate that these costs are in the range between £6 million and £8 million, depending on assumptions, and will need to be offset against the much larger savings that will accrue from 2006-07 on. The costs are explained in detail in Annex A.

### *Benefits*

26. In previous RIAs recurring costs of PVE to employers were estimated at £100 million, and the introduction of the new system in 2003 reduced these costs by £11 million. For the most recent estimate of these costs and the implied savings to employers, we have taken into account the general increase in prices and earnings, and the change in the number of employers and employees affected by PVE since the earlier RIAs. We estimate that from 2006-07 onwards the abolition of PVE will lead to compliance cost savings to business as a whole of between £110 million and £115 million a year. This is because the tasks associated with PVE will no longer have to be carried out. (Please see Annex A for further detail).

27. Employers will see their compliance costs proportionally reduced during the transition to direct payment in 2005/06. Based on annual savings of £110 million to £115 million we estimate that the savings during the transition to direct payment will be £10 million to £15 million. This is based on the timing of when stop notices are sent out, when employers action them and the annual variable costs of operating PVE.

### **Small business impact**

28. In line with the estimate of compliance costs in the December 1999 RIA, most of the savings will accrue to small employers with 99 or fewer employees. Large employers faced proportionately lower compliance costs in the first place, and this now translates into lower savings. Table 1 provides a breakdown of total compliance cost savings by employer size.

Table 1: savings by employer size

Employer size	Number of employees	Compliance cost savings (£m)
Small	1 to 4	51
Small	5 to 9	23
Small	10 to 99	23
Medium	100 to 499	10
Large	500 to 999	2.8
Large	1,000 to 4,999	2.5
Large	5,000+	1.1
<b>Total (rounded)</b>		<b>110 – 115</b>

*Note: The breakdown by employer size used here and throughout this RIA follows that used in the 1999 RIA for the original PVE scheme under WFTC and DPTC. The definitions of small, medium and large employers therefore differ from the standard breakdown now normally used.*

29. Similarly, the cost of sending one targeted letter is lower for small employers, because the main factor determining this cost is the number of employees.

## **Costs and benefits to HMRC**

### *Costs*

30. There will be recurring costs to government of abolishing PVE. These take two forms. Firstly, it is possible that there may be extra staff costs associated with maintaining WTC recipients in direct payment. Secondly, there will be the cost of paying individuals direct into an account (bank, building society or Post Office card account) or paying them by cheque where they do not have a suitable account.

31. Transitional costs will arise for publicity, including £450,000 for the mailshots that will be sent to employers in September and employees in November 2005. In addition there will be one-off costs arising from more calls to contact centres from employees, the staff cost of the time needed to transfer all recipients to direct payment and the changes to the IT system which will delete PVE functionality. These costs, plus the cost of issuing award notices to all employees who are switched to direct payment, are around £900,000.

32. A further one-off cost to government is the IT development needed to ensure that tax credits are identified by name on direct payment records that HMRC send to banks and building societies. The estimated cost of this system change is £100,000. Given that bank and building society statements routinely reproduce the details that payers provide, we do not expect these changes to impose a cost on financial institutions.

### *Benefits*

33. The costs to government are offset by the savings made. There will be a recurring saving to government from abolishing PVE. This results from the saving of staff costs associated with PVE activity in Tax Credit Office and Accounting & Payment Service.

34. Further savings are made under direct payment, as abolishing PVE will simplify the end-of-year processes and reconciliation activities, as well as reducing the call volumes for contact centres and the Employer Helpline.

35. In summary, we estimate that there are one-off costs of £1 million to £2 million to HMRC, against annually recurring benefits of between £3 million and £4 million.

### **Other impacts**

#### *Devolution*

36. There will be no specific impact on the devolved administrations: the PVE system applies equally, and will be abolished equally, in all parts of the United Kingdom.

#### *Human rights*

37. There is no impact on human rights.

#### *Environmental impact*

38. There is no environmental impact.

#### *Rural proofing*

39. There are no specific rural impacts.

#### *Impact on employees*

40. Currently some 580,000 employees receive their WTC through the payroll. We are not aware from consultation with lobby groups that employees currently have any particular problem with PVE, nor are we aware that those already switched to direct payment (for example, because PVE arrangements have broken down for some reason) have had problems in adjusting to direct payment. The agreed communications strategy for the transition will ensure all claimants affected are alerted in good time to the change in payment method. Employers will be advised how and when to take action in cases where a stop notice is received too late to be implemented in the 2005-06 tax year.

## **Competition assessment**

41. There is not expected to be any effect on commercial competition.

## **Securing compliance**

42. HMRC may pursue checks on employers' records after PVE is abolished as part of their standard PAYE compliance checks. But as employers' obligations will be significantly reduced, virtually no further compliance is involved. HMRC will, as part of their normal reviews of employers' records and systems, check that employers have complied with the requirement to write to their employees about the phasing out of PVE. It is therefore advisable for employers to keep copies they can produce as evidence if HMRC ask to see them.

## **Consultation**

43. A consultation group was established by the then Inland Revenue in 1998 to advise on the original PVE arrangements. The group has met regularly ever since to monitor how PVE is working. We consulted the representatives extensively on improvements to the scheme that were introduced when the new tax credit system began in April 2003. Please see Annex C for a list of the organisations consulted.

44. As soon as the eventual phasing out of PVE was announced in Budget 2004, we began consulting the same organisations specifically on the detail of implementation and how the transition period should be managed. The consultation covered the following aspects:

- the manner of the switch to direct payment;
- the timing of the phasing out within a tax year;
- HMRC communications with employees;
- HMRC communications with employers;
- tax credit descriptors on bank statements; and
- employer communications with employees.

45. The various options under these headings were discussed at a series of meetings in 2004. The options, and the decisions taken by Ministers, are set out in Annex B. While consultees were in favour of the phased approach to ending PVE, they would have preferred the process to start at the beginning of a tax year. However, they agreed that starting in November 2005 would be preferable to postponing the phasing out until April 2006 or later.

46. On the issue of employer communications with employees, consultees pointed out that payslip messages would be impossible for employers: most payroll software did not include a message facility at all, let alone a facility for messages of the length and detail required. In the light of this advice Ministers decided that payslip messages should not be compulsory. Employer representatives also argued against the options involving the second and third employer letters, on the grounds that there would be no way of employers knowing from the stop notice whether it was sent because the employee was about to be switched to direct payment or was no longer entitled.

47. Some consultees remained opposed to the idea that employers should be obliged to send even one letter to their employees.

### **Monitoring and evaluation**

48. HMRC will monitor the abolition of PVE throughout the process, and will include a post-implementation review. Evaluation will consist of several strands:

- to evaluate the longer term recurring savings (estimated at £110m-£115m per year), HMRC will carry out a post-implementation review of the change once the new rules have bedded down – probably around 2 years after the change. That review will focus on the level of compliance cost savings actually achieved, since that is the primary objective of the policy change;
- HMRC are carrying out a wider evaluation of tax credits, which will continue to monitor take-up during the period before and after the phasing out of PVE; and
- HMRC will continue to consult with representatives of business during and after the phasing out of PVE.

49. HMRC will also evaluate the transitional arrangements by consulting representatives of business during the transitional phase to confirm that progress is satisfactory, that the estimates of transitional costs are correct, and that any emerging concerns are identified and addressed. As part of the post-implementation review of the longer-term recurring savings from abolishing PVE, mentioned in paragraph 48 above, there may be scope to investigate the smaller transitional costs.

### **Summary**

50. The abolition of PVE is a major deregulatory measure and is in line with the Government's undertaking to cut red tape and thereby reduce employers' compliance costs. It is estimated that the benefits to business will be between £10 million and £15 million in 2005-06 and between £110 million and £115 million a year from 2006-07 onwards, with transitional costs in 2005-06 in the range between £6 million and £8 million. HMRC will make annual savings of between £3 million and £4 million from 2006-07 onwards, with transitional costs of around £1 million to £2 million in 2005-06.

51. A high-level implementation plan is attached at Annex D.

**Contact point**

Elizabeth Savidge  
HM Revenue and Customs  
Benefits and Credits Group

Room 01E/14  
100 Parliament Street  
London SW1A 2BQ

## Annex A

A1. This annex provides further detail on the calculation of estimated costs and benefits to business in this RIA. Where possible, we use existing evidence and data. Where this information does not exist, we use reasonable assumptions, allowing for a range reflecting the uncertainty around these assumptions. The process was conducted in consultation with a number of employer representatives (see Annex C). HMRC are very grateful for their valuable contributions.

A2. The general approach to the assessment of employers' costs and benefits for this RIA has followed the broad principles adopted in the RIA for the Tax Credits Act 1999, which looked at the employer compliance cost of introducing PVE under WFTC/DPTC. This approach, in turn, is in line with that of the Bath University report entitled "The Tax Compliance Cost for Employers of PAYE and National Insurance 1995-96".

A3. Several other sources of information and data have been used to calculate costs and benefits to employers in this RIA. These include:

- HMRC administrative data on the number of PVE employers and employees;
- Information gathered by employer representatives from their members;
- Results from "WFTC and DPTC: A Survey of Employers", 2003, a BMRB report; and
- The Annual Survey of Hours and Earnings (ASHE).

### **Estimating savings from abolishing PVE**

A4. Since 2002, the last time RIA work was conducted to investigate PVE compliance costs to employers, a number of key parameters have changed. There has been:

- An increase in the number of employers operating a PAYE system, who could potentially have to start operating PVE at any time;
- A reduction in the number of people receiving WTC via PVE, from an estimate of 840,000 recipients in the 1999 RIA to 580,000 in April 2005. This decrease translates into fewer employers actually operating PVE;
- An increase in the general level of prices and earnings; and
- The BMRB Report on the post-implementation cost of operating PVE under WFTC.

A5. In line with the 1999 WFTC RIA, we use administrative data on the number of employers registered to operate PAYE systems with at least one employee. A snapshot as at April 2004 is shown in table A1, where the total number of PAYE schemes with at least one employee is around 1.3m.

Table A1: Number of employers by size (HMRC COP basis)

Employer Size	Number of cases April 2004
Small (1 to 4)	935,200
Small (5 to 9)	185,000
Small (10 to 99)	191,000
Medium (100 to 499)	17,800
Large (500 to 999)	2,400
Large (1,000 to 4,999)	2,100
Large (5,000+)	600
Government (all sizes)	6,300
<b>TOTAL (rounded)</b>	<b>1,340,400</b>

A6. At the time of the 1999 RIA we needed to estimate the compliance cost to employers prior to implementation. In order to now calculate the compliance cost saving, we can refer to some of the research conducted since, in particular the BMRB Report. Table 7.15 of this report contains information on the average cost to employers of introducing PVE under WFTC, broken down by size. After taking into account the increase in prices and earnings, and the changes in the number of employers and employees affected by PVE, we get the following average saving per employer:

Table A2: average savings per employer

Employer Size	Average saving per employer
Small (1 to 4)	£60
Small (5 to 9)	£140
Small (10 to 99)	£130
Medium (100 to 499)	£620
Large (500 to 999)	£1,070
Large (1,000 to 4,999)	£1,070
Large (5,000+)	£1,070
Government	Apportioned

A7. The average costs presented in table A2 are the central cases within ranges. The total cost falls in a range between £110 million and £115 million.

## Estimating the transitional costs in 2005-06

A8. In line with the 1999 WFTC RIA, we break down the cost of sending targeted letters into its elementary components. Based on information provided by employer representatives and on the evidence on the costs of operating PVE contained in the BMRB Report, we identified three components to the cost of carrying out the above process:

- The cost of extracting the names of PVE recipients from payroll records and drafting the letter to be sent, using the HMRC guidance. This is a one-off cost for each employer (*fixed cost*).
- The cost of printing and sending the letters. This cost is directly related to the number of employees receiving them (*variable cost*).
- The cost of answering queries and providing information to employees on the phase-out of PVE (*aftercare cost*).

### *Fixed cost*

A9. The fixed cost depends on a number of parameters: the employer's size, their payroll system, the time cost to the person conducting the process, and overheads. In line with the 1999 WFTC RIA, our methodology covers the possibility of three or four different payroll arrangements for small employers, and two arrangements for medium and large employers. The distribution of payroll arrangement is given in table A3 below (derived from the BMRB Report).

A10. Small employers are assigned to one of three typical payroll systems: manual (where the sole proprietor or member of payroll staff manages the payroll process by hand), adviser (could be a high-street accountant or part-time bookkeeper) or software (essentially a PC-package operated by the proprietor or member of payroll staff). Medium and large employers are assumed to have their own internal payroll department or in some cases to use a payroll bureau.

A11. The WFTC RIA assumed that for a small employer with manual payroll, the whole process of operating PVE, including writing a pay slip, counting the cash and writing down a record would take on average 2 minutes per PVE employee. Based on this we assume that the time taken to extract each WTC-recipient's name from the payroll records (and drafting the sample letter) takes no longer than the 2 minutes per employee needed for running the whole PVE process. Furthermore, we allow another 5 to 10 minutes per employer as extra time needed to get to grips with the whole process and understand the requirements from HMRC.

A12. In line with the rationale in the WFTC RIA, we assume that the operation of the adviser and software systems take no longer than the manual system, as they are theoretically more time-efficient. We then apply the two minutes per employee to the median number of employees in the size band (i.e. in the 10 to 99 band, it would be applied to 54.5 employees).

Table A3: distribution of payroll systems

Employer size	Payroll system	% employers in size band operating system
Small (1 to 4)	Manual	32.5%
	Adviser	35.0%
	Software	32.5%
Small (5 to 9)	Manual	31.0%
	Adviser	38.0%
	Software	31.0%
Small (10 to 99)	Manual	36.5%
	Adviser	13.5%
	Software	36.5%
	Payroll	13.5%
Medium (100 to 499)	Payroll *	26.0%
	Internal **	74.0%
Large (500 to 999)	Payroll	40.0%
	Internal	60.0%
Large (1,000 to 4,999)	Payroll	40.0%
	Internal	60.0%
Large (5,000+)	Payroll	40.0%
	Internal	60.0%

\* = payroll bureau    \*\* = internal payroll department

A13. In line with Cabinet Office guidance, we use the hourly wage to put a monetary value to the time needed to send the targeted letters. We use the following rounded wage rates, taken from ASHE 2004:

- Managers and senior officials (corporate managers, proprietors): between £20 and £30 per hour.
- Associate professional and technical occupations (business/public service): around £15 per hour.
- Administrative occupations: around £9 per hour.

A14. For small employers with fewer than 10 employees, using a manual or software system, it is likely that the process will be carried out by the proprietor or director. Because of the difficulties in measuring the remuneration of company directors and proprietors, we allow the possibility of an hourly wage for directors of up to £30. The £15 wage rate is used where the process is carried out by an outside adviser/accountant. In medium and large firms, we assume that when the process is carried out internally, it is done by a payroll operative at around £9/h.

A15. We assume that the one-off payroll bureau costs for the purpose of this RIA are in a range between £16 and £27. To derive this we use information gathered from employers for the 2002 BMRB Report. Table 7.3 of the Report shows the average cost of introducing PVE, broken down into different categories. One of these categories is the “payroll bureau costs”, calculated in 2002 at £14.67 as a one-off cost. This is uprated to reflect the general increase in prices and costs, resulting in the above range. In line with recommendations from representatives and Cabinet Office guidance, wherever the process is conducted internally, we increase cost figures by 30% to take into account overhead costs such as pensions, national insurance, capital expenditure, etc. All these costs are per employer who already has a payroll bureau that deals with payroll issues.

A16. For the very large firms (5000+) which use internal payroll systems, we received a relatively representative sample of total costs from employer representatives. This sample showed that, for firms in that size band, the average total cost of sending the targeted letters would be £1,693 per employer. We assume that this covers the fixed and variable cost, and only add the cost of aftercare.

#### *Variable cost*

A17. We decompose the variable cost into the material cost of sending the letter and the time cost of producing it. We assume that the material cost per letter is £0.43, which covers both the stationery and postage. These assumptions have been deemed reasonable by employer representatives. For the time cost of producing the letters, we assume that two letters can be printed in a minute. The cost per letter is then valued at the wage rate used for the fixed cost above – and the number of letters needed is derived from the number of PVE recipients. Where the process is carried out internally, we add 30% overhead costs.

#### *Aftercare cost*

A18. We have made an allowance for the time needed to answer queries regarding the phasing out of PVE. Our understanding of this process is that the employee will obtain most information on the phasing out from HMRC and employer letters they will receive. However, this aftercare cost covers instances when the employee may want to check with their employer exactly when the last payment through the payroll will be made, how the payments will be made, etc. We would expect that for most enquiries, employers will refer employees directly to the HMRC helpline.

A19. To quantify the cost of aftercare, we have looked at the 2002 BMRB Report, where table 7.3 reports an average figure for the set-up cost of introducing PVE. This is broken down into various components, one of which is “advised general staff about availability of tax credits”, which we take to be broadly equivalent to advising staff about the future non-availability of PVE. The cost of this component is given as an average of £9.07 per employer –

we uprate this to 2005 levels to get a figure of £10.06. We use this, plus 30% overheads, to calculate the total aftercare cost from phasing out PVE.

*Total costs*

A20. The total cost of sending one targeted letter is in a range between £6 million and £8 million, rounded. This is arrived at by adding fixed and variable costs, including familiarisation costs for employers, and aftercare costs. The range results from the potential variation in some of the key parameters. Some employer representatives thought that these transitional costs could be higher: the evaluation mentioned in paragraph 48 of this RIA will seek to verify the true cost to employers of the transitional arrangements. The estimate of the cost of sending two or three targeted letters uses the same methodology as the one-letter case described above. Sending two letters would cost employers between £11 million and £13 million and the cost of sending three letters would be between £13 million and £15 million.

A21. Table A4 shows the average transitional cost per employer of sending one targeted letter. Because the main factor determining this cost is the number of employees, the cost is lower for small employers. The range provided is based on some key assumptions which are set out above.

Table A4. Average transitional cost per employer

Employer size	Number of employees	Average transitional cost per employer
Small	1 to 4	£11 - £14
Small	5 to 9	£14 - £19
Small	10 to 99	£40 - £43
Medium	100 to 499	£81 - £102
Large	500 to 999	£130 - £198
Large	1,000 to 4,999	£386 - £732
Large	5,000+	£1,315 - £1,320

A22. We estimated that the cost of aftercare is around £1.3 million and the maximum cost to all employers if they all write the letter is £8 million. All employers have to incur aftercare costs in relation to the phasing out of PVE, whether or not they send the letter – and for those who do not send the letter, the aftercare costs are likely to be even higher. We therefore estimate that the cost of making it voluntary for employers to write to their PVE employees is between £1 million and £8 million. This is based on the minimum cost that employers incur for aftercare and the maximum cost if all employers write to their PVE employees.

## **Annex B**

B1. This annex sets out the options that were considered for the transition to direct payment, specifically:

- The manner of switching from payment of WTC via the employer to direct payment (paragraphs B2 to B5);
- How this should be timed (paragraphs B6 to B10);
- How HMRC should communicate with employees (paragraphs B11 to B14);
- How HMRC should communicate with employers (paragraphs B15 to B21);
- The tax credit descriptors that should appear on bank, building society and Post Office account statements (paragraphs B22 to B25); and
- How employers should communicate the changes to employees (paragraphs B26 to B32).

### ***Manner of switch to direct payment***

#### **Option 1 - “big bang” switch for all from a specified date**

B2. This would mean that from a specified date employers would stop paying WTC through the payroll to employees and HMRC would simultaneously start paying it direct. In consultation with employer and payroll representatives it was agreed that, as well as being difficult for HMRC to manage, this approach would also place considerable strain on employers, particularly large employers, who could have large numbers of stop notices to implement at the same time.

B3. Given the demands on HMRC and employers’ systems of this approach, there would be no spare capacity for dealing with claimant queries all at the same time.

#### **Option 2 – phased approach over several months**

B4. Under this approach, PVE would be phased out over a number of months (preferably within a single tax year) rather than being abolished for all from a certain date (the “big bang” approach). The phased issue of stop notices would be more manageable for both HMRC and employers than trying to make the switch for all claimants at the same time. From a certain date no new WTC claims would be put into PVE but would be paid direct by HMRC into the claimant’s bank, building society or Post Office account. Existing PVE cases would continue as before until an amendment was needed to the daily rate the employer was paying (following a change in the employee’s

circumstances, for example). When this happened, HMRC would send the employer a stop notice instead of an amendment notice and the claimant would be switched to direct payment by HMRC.

### **Option chosen**

**B5. There was general agreement between HMRC and employer representatives that the phased approach was the better option and this was adopted.**

### ***Timing of phasing out within a tax year***

#### **Option 1 – April start**

B6. Starting the phasing out on 6 April clearly offered the best prospect of completing the transition in a single tax year. This timing would mean that the phasing out would take place alongside the normal tax credits renewal process between April and late September: by the end of September the vast majority of employees would have renewed their tax credits claims and would have been taken out of PVE. That would leave six months in which HMRC would sweep up remaining PVE cases and switch them to direct payment.

#### **Option 2 - June/July start**

B7. This would shorten the transition period to around 8 months, which would still be adequate, although it would not take full advantage of the renewals period between April and September.

#### **Option 3 – October or later start**

B8. Starting the phasing out in October or later would mean that the process could not benefit from the renewals process between April and September to achieve a “natural” phased withdrawal as people renewed their claims and could be taken out of PVE. If the phasing out started in October, no new WTC claims would be put into PVE from that date.

B9. As claimants reported a change of circumstances after the start of the phasing out, they would be taken out of PVE. In addition, HMRC would take steps to ensure that, as far as possible, all PVE cases were switched to direct payment well before the end of the tax year. HMRC would select batches of remaining PVE cases in November, December and January and push them through a “pseudo” change of circumstances to end PVE and set up direct payments. This would need to be done in time for employers to make their final PVE payments before the end of the tax year in April. Consequently, it was felt that this timetable should start no later than October/early November.

### **Option chosen**

**B10. Once it became clear that it was too late to plan for the phasing out to begin in April 2005, the view of employer representatives was that**

**an October/November 2005 start would be preferable to continuing PVE into the 2006/07 tax year. The Government chose this option and will proactively try to ensure that as far as possible, all employers are sent stop notices well before the end of the 2005-06 tax year.**

### ***HMRC communications with employees***

#### Option 1 – do nothing

B11. This would involve simply sending the employee a revised award notice at the point when he or she is to be taken out of PVE – as happens now when an employee is switched to direct payment because of problems with PVE. The new award notice would, as now, show the revised method of payment.

B12. This is not an acceptable option because it would not prepare claimants adequately for a significant change: they might well believe they were losing money when WTC no longer appeared on their payslips. This in turn would generate queries to employers' payroll departments as well as to the Tax Credit Office. For these reasons the Government rejected this option, because it did not satisfy the communications strategy for the phasing out process.

#### Option 2 – HMRC sends targeted letters to PVE employees

B13. This would mean that HMRC would write to all PVE employees individually in advance of the start to the phasing out to explain the process and how it would affect the employee. Employees would then know what to expect and the revised award notice that they would receive at the time of the change would show them that direct payments were about to begin.

#### Option chosen

**B14. It was agreed that option 2 was the better option and the Government decided that the message in the Department's targeted letters should be repeated in similar targeted communications from employers (see paragraph B30 below).**

### ***HMRC communications with employers***

#### Option 1 – do nothing

B15. This would mean HMRC simply sending employers stop notices for all their PVE employees during the transition period and not sending them any further start notices. PVE would therefore cease to exist without any formal explanation.

B16. This was rejected, because the Government felt they should provide appropriate support to employers when introducing an important change, including making them aware of the change.

#### Option 2 – use regular HMRC publications

B17. Under this option HMRC would use its regular publications to alert employers and payroll software designers to the fact that PVE was being phased out. These publications include the *Employer's Bulletin* (sent three times a year to 1.5 million employers) and the *Notes for payroll software developers* (sent to payroll software designers several times a year).

B18. While these publications should reach most employers and payroll software designers, there would always be the chance that they wouldn't read the articles and would therefore not be aware that PVE was ending.

B19. It was therefore decided that this option on its own would not be enough to prepare employers adequately for the change.

#### Option 3 – targeted mailshot to all PVE employers

B20. Under this option, as well as using their regular publications HMRC would send targeted letters to all PVE employers in advance of the phasing out, explaining exactly how the transition would work and how it would affect them.

#### Option chosen

**B21. Ministers felt that the best option would be a combination of options 2 and 3. HMRC would alert employers generally in the *Employer's Bulletin* and payroll designers in *Notes for payroll software developers* and would send a targeted mailshot to all PVE employers in September 2005.**

### ***Tax credit descriptors on bank statements***

#### Option 1 – do nothing

B22. This would mean continuing the current practice whereby all direct payments of tax credits are described as "Tax Credits" on the payment records that HMRC sends to banks and building societies when making direct payments. This is the descriptor that subsequently appears on claimants' bank, building society or Post Office account statements.

B23. The drawback to this option is that it does not distinguish between WTC and CTC payments. So the employee would no longer have the visible proof that work pays that is currently provided under the PVE system, whereby the WTC is shown on the employee's payslip for each pay period.

### Option 2 – change descriptors produced by HMRC IT system

B24. Under this option HMRC would make changes to its computer system so that all direct tax credit payment records would show which tax credit was being paid. The descriptors would show whether the payment consisted of CTC only, WTC only or a combination of both.

### Option chosen

**B25. The Government decided that option 2 should be implemented. In order to provide claimants with the greatest possible clarity, and to use descriptors that were within the 18-character limit imposed by the banks and building societies, the descriptors should be “Child Tax Credit”, “Working Tax Credit” or (for a payment including both tax credits) “Working & Child TC”. This change will come into effect from 7 November 2005. The childcare element of WTC would be included in the CTC payment, as now.**

### ***Employer communications with PVE employees***

#### Option 1 – do nothing

B26. This option would mean that, when HMRC issued a stop notice, employers would stop WTC payments and would do nothing other than carry out HMRC instructions. This option was rejected because it did not satisfy the Ministerial requirement that employees should be told about the change in payment method by both HMRC and their employer.

#### Option 2 – employers display general publicity in the workplace

B27. Under this option employers would be asked to display posters in the workplace and to publicise the change in staff magazines. This was thought to be a good way of raising employees’ awareness of the imminent switch to direct payments.

#### Option 3 – employers send targeted payslip messages to PVE employees

B28. Under this option employers would send messages on or with payslips alerting employees to the imminent change in payment method

B29. However, as payroll software is not normally designed to allow for detailed payslip messages of the length that would be needed to explain the phasing out of PVE, the Government decided that this option should not be obligatory. However, employers who had an appropriate payslip message facility could, if they wished, make use of it to send the targeted message to their employees.

#### Option 4 – employers send one targeted letter to PVE employees

B30. Employers would send one targeted letter to each PVE employee shortly before the date on which the phasing out of PVE would begin. The letter would explain the impending change; assure employees that they would not be losing money, as WTC would be in future be paid by HMRC direct into his bank, building society or Post Office account; and directing them to the Tax Credits Helpline should they need more information.

#### Option 5 – employers send two targeted letters to PVE employees

B31. Employers would send the letter mentioned in paragraph B30 above and a further letter on receiving a stop notice from HMRC. This second letter would tell the employee that his next payslip would show the WTC payment for the last time on his payslip. Subsequently, if the employee remained entitled to WTC, this would be paid by HMRC direct into his bank, building society or Post Office account.

#### Option 6 – employers send three targeted letters to PVE employees

B32. Employers would send, as well as the first and second letters referred to in paragraphs B30 and B31 above, a third letter during the first pay period in which WTC would not appear on his payslip.

B33. The deciding factor against options 5 and 6 was the fact that the employer would have no means of knowing whether a stop notice had been sent because the employee was being switched from PVE to direct payment, or whether the employee had simply ceased to be entitled to WTC. So it would be impossible for the employer to know which employees should receive the second and third letters.

#### Other options considered: HMRC assisting employers to write letters

B34. We also considered the options of employers' sending one, two or three targeted letters which HMRC would write and address to the employee, so that all the employer would have to do would be to print the letter(s) on company notepaper and forward to the employees. This would have reduced employer costs, but the option had to be rejected because our solicitors advised that under the Data Protection Act HMRC could not disclose to an employer the address we had been told by the employee. This is because the Act requires us to state the use to which we will put data provided to us and to whom it will be disclosed.

#### Option chosen

**B35. Ministers decided that the most effective way for employers to communicate with their PVE employees would be by a combination of option 2 (posters and similar publicity material in the workplace) and option 4 (under which employers would be required to send one targeted letter to their PVE employees).**

## **Annex C**

### **Organisations consulted on PVE in general and on the transitional arrangements for phasing it out**

British Chamber of Commerce

British Computer Society

Chartered Institute of Taxation

Charities Tax Reform Group

Confederation of British Industry

Federation of Small Businesses

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants in Scotland

Institute of Directors

Institute of Payroll and Pensions Management

Payroll Alliance

Private Sector Payroll Group

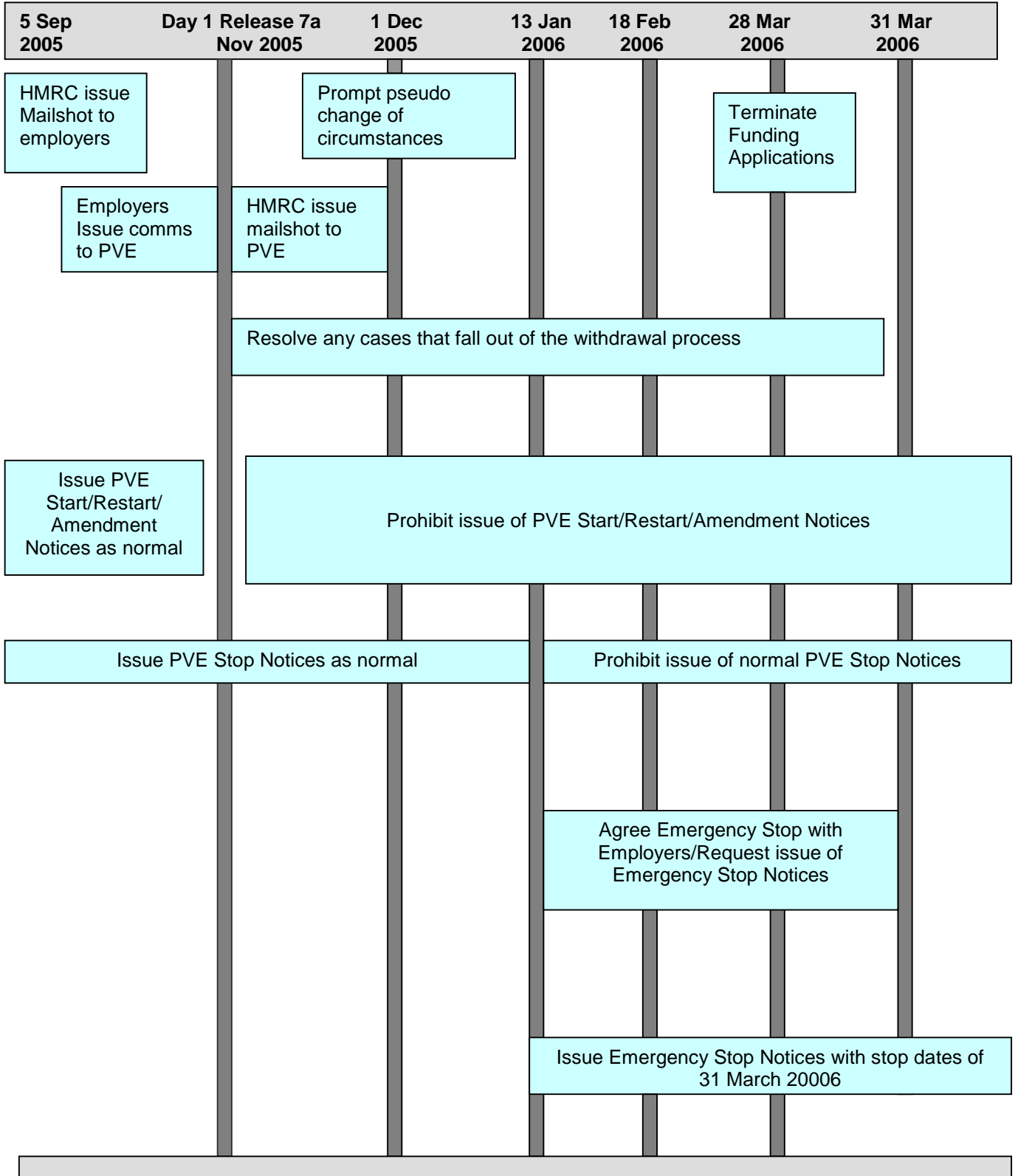
Small Business Council

Small Business Service

Social Security Advisory Committee

**Annex D**

**Timeline for the withdrawal of PVE**



## REGULATORY IMPACT ASSESSMENT

### The abolition of payment of Working Tax Credit via employers

#### Statement of Ministerial Approval

I have read the regulatory impact assessment and I am satisfied that the benefits justify the costs.

Signed by the responsible Minister:

*Dawn Primarolo*

22nd July 2005