

## REGULATORY IMPACT ASSESSMENT (RIA)

### Payroll Services (Electronic End of Year Filing of Employer Returns)

#### 1. Introduction

1. At the Pre Budget Report of November 2001 the Government published businessman Patrick Carter's Review of Payroll services. This review was set up to identify ways of reducing the total cost to business and the economy of compliance with payroll obligations. A copy of the report can be found at [www.inlandrevenue.gov.uk/pbr2001/carter\\_review.pdf](http://www.inlandrevenue.gov.uk/pbr2001/carter_review.pdf) Following a period of consultation the Chancellor announced in April 2002 that – in line with the Review's recommendations - over time all employers would be required to submit their PAYE end of year returns electronically, with financial incentives available to small employers who adopted electronic filing earlier.
2. A partial regulatory impact assessment was issued in April 2002 setting out the options that the Government had considered, taking account of the views of respondents in this first consultation period, on the Review of Payroll Services.
3. Draft regulations were made available for comment in April 2003. This final Regulatory Impact Assessment addresses the impact of the detailed proposal set out in the final version of these regulations and the Board's Directions made under these regulations. (Board's Directions are formal requirements that the Inland Revenue are empowered to make under the primary legislation, in addition to being empowered to make regulations by Statutory Instrument.)
4. However, these regulations and directions are only part of a much wider programme of change in this area not involving regulations – for example, the improvement of registration and other e-filing processes and services, the improvement of software test services, and improvements to Inland Revenue processes that are expected to improve quality of service to employers and individual taxpayers. The internal Inland Revenue business case (for Modernisation of PAYE Processes for Customers – MPPC), currently being prepared (for submission to Treasury this autumn), is for this much wider programme. As a result, it is difficult in any meaningful fashion to extract the costs (or benefits) of particular options specifically covered by these regulations and Board's Directions. Although in isolation, some individual options may appear to offer a poor financial return, overall, the return anticipated for the whole investment facilitated by these regulations is strongly positive.
5. The following regulations
  - The Income Tax (Employments) (Amendment) Regulations 2003
  - The Income Tax (Incentive Payments for Voluntary Electronic Communication of PAYE Returns) Regulations 2003cover:
  - compulsory electronic filing of the end of year return for two groups of employers

- employers with 250 or more employees who will have to submit to the Inland Revenue their return<sup>1</sup> electronically starting with the return for 2004/05 due by the 19 May 2005;
  - employers with between 50 and 249 employees who will have to submit to the Inland Revenue their return electronically starting with the return for 2005/06 due by the 19 May 2006;
  - incentives to be paid to employers with fewer than 50 employees starting for 2004/05 at a level of £250 and tapering to £75 by 2008/09. Current Government proposals are to make electronic submission compulsory for this group of employers in 2010.
- 5.1 The use of the word 'employer' includes payers of employment income and includes private pension providers.
6. Board's Directions, which will be published when these Regulations are in force, will state that Electronic Data Interchange (EDI) and the Internet service, PAYE Online for Employers, will be the only acceptable electronic transmission routes from 2004/05. Employers who continue to use Inland Revenue's Magnetic Media service will not have filed electronically and, if small employers, will not qualify for the incentive payment.
7. The full text of the Regulations can be found at [www.inlandrevenue.gov.uk/si/index.htm](http://www.inlandrevenue.gov.uk/si/index.htm). In due course the Directions will be made available at [www.inlandrevenue.gov.uk/ebu/irboadir.htm](http://www.inlandrevenue.gov.uk/ebu/irboadir.htm). As a result of representations made in the second period of consultation, the final version of these regulations has been amended in the following areas:
- the latest date for the Inland Revenue to assess the size band for an employer has been brought forward from 31 January to the previous 30 November;
  - there is a new requirement for the Inland Revenue to issue notices about this size band assessment to employers by 31 December.
8. The regulations named above specifically address the need to send the tax information included in employers' end of year returns electronically. But the Review of Payroll Services proposals cover all elements of the employer's end of year return. Additional regulations will also be made by April 2004 to replicate the requirement to send tax information electronically for:
- National Insurance contribution information;
  - Student Loan deductions;
  - Tax Credit payments;
  - Payments of Statutory Sick pay, Statutory Maternity pay, Statutory Adoption pay and Statutory Paternity pay.

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<sup>1</sup> Employer returns are required by Reg 43 SI 1993/744. Employers who make returns required by Regs 88, 102 or 104 SI1993/744 will not have to file electronically.

- 8.1 This Regulatory Impact Assessment addresses the impact of the changes in all these areas and includes their costs and benefits.
- 8.2 This Regulatory Impact Assessment takes account of the incentive payments to employers of fewer than 50 employees. A separate Regulatory Impact Assessment will look at the impact on that sector of compulsory electronic filing of end of year returns when regulations requiring those returns are brought forward. None of the costs or wider benefits of e-filing by this group are recognised in this RIA.

## **2. Purpose and intended effect**

9. The Government considers that the best way to help employers deal with their payroll tasks is to encourage greater use of new technology. The package of measures aim to support this strategy through:
- financial incentives intended to help small employers make an early switch to technology and realise the benefits to their business;
  - the use of new technologies and software or services which meet Inland Revenue's Quality Standard (a newly-published set of validation checks) thereby reducing the number of errors both during and at the end of the year;
  - a near instantaneous response from Inland Revenue to the submission of electronic data;
  - a secure transmission route.
- 9.1 The package of measures will also lead to:
- quicker allocation of National Insurance contributions data to citizen accounts which in turn will lead to more accurate payments of relevant State Benefits;
  - faster determination of an employee's tax liability in turn leading, where appropriate, to faster refunds to individuals;
  - quicker payments being made to private pension providers.
10. It is anticipated that having made the investment in the relevant hardware and payroll software, or appointed an intermediary, employers will also be encouraged to take advantage of other Inland Revenue electronic services particularly to receive and provide in-year related documentation electronically. This will bring further benefits through less paper handling, reduced manual intervention and more accurate data being transmitted.
11. Finance Act 2002 provides Inland Revenue with the power to make regulations and Board's Directions requiring returns electronically from specific customers. This includes a power to impose a penalty (with appeal rights) if a return is not received by an authorised electronic transmission route.

## **3. Risks**

12. The UK Government is committed to developing the UK as the best environment for electronic business. The Government wants a vibrant competitive business community using e-commerce to excel, and seeks to ensure that the UK is a world-

leader in the new knowledge economy. Fundamental to achieving this is to ensure that all main Government services are available online by 2005, and implementing the recommendations of the Review of Payroll Services on e-filing and incentives, within the wider investment context, will help to achieve these goals. Failure to implement the recommendations would damage these business focused goals and dilute the benefits of removing unproductive paper work.

#### 4. Options

##### 13. Option 1 - Do Nothing Option.

13.1 Inland Revenue already provide an electronic service which employers can use at both the in-year stage and for the submission of their end of year returns. These services have been available since 1999 (EDI) and 2001 (Internet). Voluntary take up has been slow with some 23,000 employers from a total of 1.2m submitting their 2002/03 end of year return electronically. This represented 11.58% of the employee returns.

| Date       | Percentage of total submitters (1.2m total employers) | Percentage of total employee reports (55.2m total employees) |
|------------|---|--|
| April 2001 | 0.73%   | 8.56%  |
| April 2002 | 0.8%  | 11.41%   |
| April 2003 | 1.61%   | 11.58%   |

13.2 Without legislative support the current take-up rates would take an indefinite period to achieve universal electronic submission. In the meantime Inland Revenue would continue to incur costs, currently running at £9.3m. p.a. to capture the receipt, logging, storage and retrieval of paper end of year returns and the costs to capture data from the magnetic media submissions. Inland Revenue would also forgo the reduced costs of rework mentioned in para 14 and employers would miss the 'right first time' savings which are a high priority for them.

13.3 A continued low take-up would significantly reduce the potential for growth in the payroll bureau and intermediary market, with the added cost of this market being unable to capitalise upon the economies of scale that an increased customer base provides. There is the risk that the opportunity to promote the benefits of new technology to employers may be missed with the consequential loss to their business of the potential to capitalise on the benefits of e-commerce. This will be of particular relevance to the small employer where the burden of payroll is disproportionately expensive<sup>2</sup>. The benefits missed could extend beyond payroll to those that would be obtained from a more extensive use of new technologies in their business generally.

##### 14. Option 2 – Mandatory electronic returns, which meet a specified standard.

14.1 The Report of the Review of Payroll Services expressed concern about the poor quality of employer end of year returns (para 6.22) and recommended that one way to improve quality would be to provide details of a quality threshold. Currently Inland Revenue incur costs correcting the errors from employer returns and without action

<sup>2</sup> 'The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995/96' which can be found at <http://www.inlandrevenue.gov.uk/pdfs/bathv1.pdf>

this burden would continue. Based upon experiences with Magnetic Media neither employers nor the Department will secure a gain in quality without imposing tighter expectations of quality. And failure to provide data in the correct format would mean the return would not process. Without the Quality Standard employers would have no assurance of the calibre of products or services where developers have chosen not to design them to meet the requirements of the Inland Revenue Payroll Standard. Software that meets the Quality Standard will help employers get payroll right first time across a wider range of products than have sought accreditation under the Payroll Standard arrangements. Details of the Inland Revenue's Payroll Standard can be found at [www.inlandrevenue.gov.uk/ebu/psu.htm](http://www.inlandrevenue.gov.uk/ebu/psu.htm)

- 14.2 Consultation established the appropriate level for the threshold and in April 2003 the *Quality Standard Validation Specification from April 2004* was published. It can be found at [www.inlandrevenue.gov.uk/ebu/qual\\_stand.htm](http://www.inlandrevenue.gov.uk/ebu/qual_stand.htm) This standard sets out precisely what data the electronic return must contain and how it is to be presented in an electronic format. Employer returns which fail to meet the Quality Standard will lead to the rejection of the return with an error message intended to help the employer to make the necessary corrections. But the real aim of the Quality Standard is to encourage the development of payroll software that produces the right answer. To support this aim the Inland Revenue will be enhancing their test services both for payroll software in its development stage and to enable the employer to test end of year returns before final submission.
- 14.3 There is a risk that in the face of a high rejection level, employers, particularly large employers, will ignore the quality standard and make a non-electronic submission leaving the Revenue to make the corrections, as now, even though this will result in a non-electronic-filing penalty. To reduce this risk the payroll software industry is being encouraged to design their product to identify the errors immediately they occur during day to day use, and not to leave the identification until the year end; thereby providing the user with considerably more time for error correction. The Inland Revenue's electronic services will also provide near-instant identification of errors at the Inland Revenue's electronic gateway, eliminating the current delays before there can be a direct approach from the Inland Revenue to the employer seeking help to correct a return made on paper or Magnetic Media. This issue has irked employers for some years.
- 14.4 As the take up of electronic filing to the required standard extends throughout the employer community, further resources within Inland Revenue will become available to help and support the less confident employers. But there is a risk that this support will be missed if the take-up of electronic filing is slow.
15. Option 3 – The payment of incentives to small employers.
  - 15.1 The initial Ministerial announcement in April 2002 highlighted the payment of an incentive to assist and encourage smaller employers to make greater use of IT. 1.16m. employers with fewer than 50 employees will be able to take advantage of the payment if they send their end of year returns electronically. The payment of the incentive will help the small employer to defray their costs of purchasing a computer or payroll software; or the costs of arranging for a payroll bureau or intermediary to handle payroll on their behalf. There is a risk that the number of small employers taking up the incentives will be low, so that the opportunities for small businesses to realise the benefits of new technology at an early date are missed. But the Inland Revenue is taking, and will continue to take, steps to raise awareness of the incentives and the benefits of switching to technology.

- 15.2 Consideration has also been given to paying the incentive to those employers using the simplified deduction scheme<sup>3</sup>. Inland Revenue already provides electronic filing facilities for these employers and it has therefore been decided to pay the incentive to this group of employers, if they file electronically. If all the employers in this group used the electronic filing arrangements and were entitled to an incentive for the whole of the 5 year transitional period the cost would be £12m of the £420 million of public funds set aside for incentives. Payment of the incentive to this group of employers is consistent with the approach taken with small employers using the Inland Revenue facility, Forms Online, who will also be paid the incentive.
- 15.3 However the conclusion drawn is that the payment of incentives at an affordable level to small employers would, on its own, be insufficient to bring about the behavioural change of greater use of electronic transmission routes that the Carter review recommended.
16. Option 4 – To treat Magnetic Media submissions as being non-electronic submissions
- 16.1 For more than 20 years Inland Revenue has enabled employers, large and small, and agents to submit their end of year returns via Magnetic Media. Magnetic Media transmission does not permit automated validation and the identification of errors, effectively in real time, nor fast automated messaging from the Inland Revenue. As the Report of the Review of Payroll Services noted, “the majority [of large employers] file by magnetic media often of dubious quality”. 57,000 Magnetic Media returns, covering 29 million employee summary details, are received each year by Inland Revenue. 24% of the employer returns require remedial work both in Inland Revenue and by the employers. This costs Inland Revenue £2.25m. p.a. The current practical experience is therefore unsatisfactory for both Inland Revenue and employers. The nature of the transmission medium limits the scope for improvement. Accordingly, the Government has rejected Magnetic Media as an authorised electronic means of submission. There is a risk that some large employers will continue to use Magnetic Media and incur a non-electronic filing penalty rather than change their transmission route to the Internet or EDI. To help these employers to understand the wider implications and benefits to them, each is being specifically targeted as part of the e-recruitment process so that their queries can be handled very quickly. These 4% of employers submit about 52% of employee end of year data.

## **5. Benefits**

17. The option being implemented, and on which these costs and benefits are based, is a composite of
- mandatory electronic filing for medium and large employers;
  - a penalty on large and medium-sized employers who fail to comply;
  - payment of an incentive to small employers;
  - the introduction of a quality standard which all employer end of year electronic returns must meet;

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<sup>3</sup> specified in Reg 20 SI 1193/744

- use of the internet or electronic data interchange as the only acceptable means of electronic transmission.
18. Benefits of compulsion arise because of the inherent value to all participants in the payroll process from improved or increased quality of data. Dealing with errors is a costly process in itself, and it takes senior employees' or managers' time to fix, often some time after the event.
19. In principle benefits arise to both employers and the Revenue. It may be surmised that with an increasing standard of data quality and electronic transmission of data the benefits ought to accrue to Revenue in the first instance. But in practice it appears that the benefits are going to be spread much more widely. Furthermore, the proposed approach opens up new possibilities for other services to piggyback on the platform of good quality end of year data and good transmission mechanisms. These include the benefits from being able to offer new and/or additional services which would not have been possible in a cost effective way if the data was below a certain standard.
20. Benefits are described below for each group of employers:
21. Benefit 1. Large and medium employers (250 or more employees – large) and (50 to 249 employees – medium):
- secure transmission of end of year forms – including speed and certainty of end of year receipt and processing of returns;
  - payroll software which validates data as it is entered so that errors can be corrected before the end of year, and other gains from cleaner data;
  - faster transmission of PAYE “movements” (the PAYE process when someone changes jobs) information (where appropriate) and the faster receipt, by the employer, of tax codes which in turn will lead to employees paying the right amount of tax;
  - miscellaneous savings from reductions in volume of paper, printing and storage of paper with consequential savings on postage plus not insignificant overheads in respect of staff time in handling paper;
  - large and medium employers will see the benefits from dedicated trained resources (e-recruiters), being made available by the Inland Revenue for the purposes of helping employers move to online filing. This help will enable employers to provide a cleaner return containing fewer errors which in turn will lead to quicker processing. This will be a much smoother process valued as a service to business, and will achieve a better result as regards employer compliance;
  - second order effects in employer organisations (not necessarily small), eg, better integration to payments systems and BACS.
22. Employers gain from the implementation of the quality standard in their payroll software. For the very largest employers this starts with the cleaning and Works Number Update phase. This brings an enduring quality benefit that is projected in to the future. The judgement is that those employers using electronic transmission routes are likely to see substantial benefits from going further than just the end of year processes.

23. Putting values on the respective components of benefits is difficult and raises difficult valuation issues about what is the basic value of clean data. Only very broad judgements can be made based on what each of the above parties would be willing to pay to establish a benchmark of value for the clean data.

24. Benefit 2. Employers with fewer than 50 employees:

- take up is voluntary until 2009/10;
- during the transition period some small employers will take up the incentive payments, with added value as they are tax free in the hands of the employer. The incentive payments are:

| 2004/05<br>return due<br>by 19 May<br>2005 | 2005/06<br>return due<br>by 19 May<br>2006 | 2006/07<br>return due<br>by 19 May<br>2007 | 2007/08<br>return due<br>by 19 May<br>2008 | 2008/09<br>return due<br>by 19 May<br>2009 |
|--|--|--|--|--|
| £250                                       | £250                                       | £150                                       | £100                                       | £75  |

- it is anticipated that new employers, or those employers who make substantial changes to their software system, will upgrade to 'electronic transmission enabled' payroll software, at the first opportunity;
- alternatively employers will use the services of an intermediary. Although they will have to pay for this service they will in turn gain from the value of time released by being relieved of payroll tasks;
- employers will gain certainty, convenience and assurance that the end of year process has been finished when the figures are checked in the on-line session;
- there will be more focused support for small employers particularly once the larger employers have moved to electronic filing;
- second order effects in employer organisations (not necessarily small), eg, better payroll system management;
- In the near future some gains from competition in the market for payroll services which may reduce the costs of the services of the intermediary.

25. Benefit 3. Intermediaries:

- New entrepreneurial opportunities for business to take on new work where intermediaries provide a wider and sometime more specific range of services e.g. employment law services, assistance with human resource issues as well as more traditional areas such as business accounts and tax planning;
- after some internal investment in new software and training, there is a likely boost to profits from taking on more payroll work and/or reorganising to take advantage of the incentives paid to the employer. This is already involving more marketing by payroll suppliers themselves;

- increased opportunities for software houses to sell retail payroll software to replace manual processes;
- more scope for “niche marketers” as well as those addressing the mainstream payroll market;
- the improved test service and the Quality Standard, together with the existing Payroll Standard, give retail and in-house software developers, and potential customers, greater assurance of the effectiveness of their products;
- increased opportunities for the bespoke software end of the market, eg, software that meets the specific needs of shipping companies, coupled with the economies of scale that electronic communications allow intermediaries to capitalise upon.

26. Benefit 4. Inland Revenue:

- Secure receipt of data coupled with a quicker processing and response to employers;
- greater use of electronic end of year services leading to less handling of paper returns, a significant reduction in the amount of keying undertaken by Inland Revenue where the current cost for validation, capture and subsequent retrieval of data alone is £6.9m p.a. Better checking and other gains from cleaner data will lead to a quicker match of returns to employee’s tax and national insurance records; coupled with the use of payroll software this will lead to a more accurate employer return. Business benefits in these various areas combined creates a saving of £45.5m during the period to 2010;
- evidence from focus groups, discussions and current experience with employers has shown that once the initial investment in hardware, software and staff training has been made, employers will do more of their business with Inland Revenue electronically leading to savings to the Revenue of £23m over the years to 2010. These savings are based upon a take up rate of the electronic PAYE movements services (details of employees starting and leaving employment) of 5% rising over the 5 years to about 35% specifically attributed to these regulatory changes;
- separate reductions in forms/stationery which will reflect the rate of e take-up. It is anticipated that these regulations will secure a saving of the order of £22.7m over the years to 2010;
- reductions in paper storage will lead to small accommodation savings, spread across the IR estate but these will be slow to realise.

**6. Policy Costs**

27. The incentive to the small employer is treated as a benefit to the employer and an equal and opposite Exchequer cost. The size of the benefit/cost is determined by the number and timing of small employer take-up of electronic filing. As this is voluntary there is considerable uncertainty as to the numbers taking up and timings. The Treasury have set aside £40m in the first year (payments in 2005/06), £110m in the

two subsequent years and £420m in all to give direct cash help to small firms going on-line.

## **7. Implementation Costs**

28. There is no such thing as one typical business. To look at cost, five typical businesses need to be covered and analysis has been undertaken in five different Case Studies. These studies are too technical for inclusion in full in this Regulatory Impact Assessment, however they are available on request from the contact named below.

28.1 The five case studies set out an indicative incremental analysis of costs of moving from present payroll system to the EDI or internet compliant system. For most of the above schemes the costs and benefits broadly arise from replacing:

- magnetic media based submission; or
- paper, but with a computerised payroll system underlying the system.

29. Large Employers using the Electronic Data Interchange (EDI) (Case Study 1)

The Inland Revenue's Electronic Data Interchange Service is a managed service that sends and receives information to and from the employer either directly or through the services of a third party without manual intervention. Typically the largest employers who have a large amount of data to transfer or large Payroll Bureau use EDI. Broadly costs include setting up costs of:

- installation of new software or of upgrading the current software to EDI standard;
- development costs for meeting the Quality Standard where in house software is used;
- costs associated with installing and testing the transmission method; and

Ongoing costs:

- associated with using a third party service or maintaining a direct line;
- of ongoing transmission charges.

30. Employers using software, developed in-house (Case Study 2) and employers who purchase software (Case Study 4)

Both these groups of employers are likely to send data over the Internet rather than Electronic Data Interchange. It is anticipated that this will be the preferred option for the vast majority of employers. Broad costs are based on the basic IT (computer and Internet connection) being in place. These are:

- one off costs of relating to the installation of new software or of upgrading the current software to Internet standard;
- development costs for meeting the Quality Standard; and

Ongoing costs of:

- transmission to send data over the internet (dependent on size and timing of the information sent).

31. Employers using the Inland Revenue's Online forms (Case Study 3)

The Inland Revenue provides a facility for completing Employer End of Year returns on screen and sending the data over the Internet. This is aimed at the small employer who does not already use payroll software; the service does not replicate

payroll software functionality. The nature of the service means that it is most cost effective for employers with a small number of employees. Again the broad costs are based on the assumption that the employer has access to a computer and Internet facility. The on-going costs are:

- costs of time taken during online registration for the Inland Revenue PAYE Online for Employer Service;
- costs of completing Employee Summary details on-line (say 5 minutes per form);
- costs of correcting any validation errors while still on-line;
- cost of transmission and staying on-line for the acknowledgement of receipt.

32. Employers who use an Intermediary (Case Study 5)

Costs for employers using an intermediary will depend on what services are being used and whether there is a service level agreement in place. Following compulsion it is expected that there will be some change to costs of using an intermediary. However the use of an intermediary will bring considerable benefits to the employer who will be relieved of the routine payroll function and the burden of decisions about the application of tax and National Insurance rules.

33. The table below is a composite table of costs of change. It includes a considerable number of assumptions about those employers with only an incremental cost of moving which is especially so for those in case study 4. The case study 5 incremental costs are different from the case studies 1 to 4 costs in that they are the market prices that will be charged by intermediaries for meeting the legislative requirements over and above what was charged in the period before the legislation. It is expected that there will be significant shifts towards the use of more proprietary software (case study 4) and somewhat more use of intermediaries (case study 5).

34. There are 45,000 employers with 50 or more employees. Their costs are greatest in the first year (mainly one off setting up costs) but some cost may be incurred in later years.

Costs to employers (with 50 or more employees) of adopting compliant systems – 2004-05

£ million

| Case study | Case study | Case study | Case study | Case study | Total |
|------------|------------|------------|------------|------------|-------|
| 1          | 2          | 3          | 4          | 5          |       |
| 2.8        | 3.2        | 1.0        | 12.8       | 6.8        | 26.6  |

35. The change in costs in each of the various cases reflects a more detailed analysis which separately considers changes by employer size within each case type. Thus for the case study 4 there are £12.8 million of first year costs comprised of employers switching at the bottom end of the size distribution from a mix of manual and ad hoc software to a proprietary payroll software solution with internet included. Case study 5 is comprised of some £6.8 million of costs which reflects other employers switching to intermediaries (of all types) instead of self completion.

36. Recurrent costs arise in all of the next five years since costs are measured against what they would be if mandatory e-filing was not introduced and there was only minimal voluntary, change in method of submission.

Recurrent cost for the years 2004-05 to 2009-10

|         | 2004/05 | 2005/6 | 2006/7 | 2007/8 | 2008/9 | 2009/10 |
|---------|---------|--------|--------|--------|--------|---------|
| Cost £M | 26.6    | 14.3   | 13.8   | 13.5   | 13     | 12.5    |

37. The recurrent costs are dominated by the ongoing payment of licence fees to software houses and the shift to the use of the intermediaries. There is some gentle decline reflecting both a learning effect and a presumption that there would have had some upward drift towards the use of more software even in the absence of compulsion.
38. The total of one-off and recurrent compliance costs, for the years 2004-5 to 2009-10, as given in the table above, is £81.5m. in discounted terms to 2003/4 prices.
39. Intermediaries/Software Developers
- There is a largely one-off development cost for upgrading current retail software products to meet the electronic filing requirements. This is likely to produce an overall efficiency gain as these development costs are spread over the existing licensed software users;
  - there will be an expanded market for software and intermediaries – though there will be some initial learning and software familiarisation costs to be recouped;
  - in-house software development costs will be incurred making sure that products meet the Quality Standard. Note that in cost/benefit terms incentive payments are benefits to employers but equal and opposite costs to the Exchequer;
  - the incentives are likely to expand the user base of retail software and intermediaries which should be a bonus to them and to overall efficiency.
40. Inland Revenue's implementation costs
- Inland Revenue's costs can be attributed to:
    - the changes to IT structures to enable an employer to organise their payroll to suit their business needs and make returns in any number of fragments using a variety of transmission routes;
    - changes to the PAYE Online for Employers Internet service so that very large end of year returns can be submitted by compressing and/or fragmenting the return, this will allow the very largest employers to choose between Electronic Data Interchange or the Internet service;
    - improvements in the Registration process for the PAYE Online for Employers Internet service;
    - the provision of a data-base of those employers who use the services of a bureau or intermediary. This data-base will significantly enhance the services Inland Revenue provide to 52,000 bureaux and intermediaries who act on behalf of employers and reduce the number of contacts that need to be made with them, and enable agents to e-file more easily on their clients' behalf;
    - the provision of the infrastructure to enable incentives to be paid to small employers who voluntarily e-file and penalties to be imposed on large employers who fail to e-file;

- the development of the Quality Standard which will be built into electronic gateways leading to the rejection of returns which fail to meet the standard.;
- enhancement of the test services provided to software developers and employers.

The costs to build and maintain these systems over the period to 2010 is £48m.

- Employers will need to be supported both to make the transition from their current filing arrangements and to understand the electronic requirements. Additional support from the Regional Employer recruitment Teams, Business Support Teams, Online Services Helpline staff and from the Employer Helpline will cost an additional £58m in the period to 2010.
- The detail of these regulations, the marketing of the benefits of doing business with Inland Revenue electronically as well as providing the low level detail of the arrangements will cost an additional £3.9m.
- There will be some increase in the charges by the electronic gateway providers. These costs are not yet known and are dependent on traffic volumes, but are likely to be of the order of £1.5m p.a. for EDI and £1m p.a. for Internet submission.

## **8. Cost/Benefits to Inland Revenue**

41. These regulations form a part of much wider plans within Inland Revenue to make process changes to streamline PAYE end of year work, support the automation of Inland Revenue systems and take advantage of the wider benefits from greater use of electronic submission with minimal clerical intervention. Whilst these regulations create an overall net cost to the Exchequer they put Inland Revenue in a position to take advantage of the much wider benefits which their Programme Modernising PAYE Processes for Customers seeks to achieve. As it currently stands, the emerging business case is expected to provide a net benefit in the range from £70m to £100m annual savings.
42. The bulk (40%) of the costs of these regulations are incurred in the first two years in order to give large employers comprehensive e business functions for PAYE from the outset. 50% of the benefits accrue in the two years to April 2010.
43. The Partial Impact Assessment was published in April 2002. The Inland Revenue's net benefits have subsequently decreased. This is due to the:
  - provision of services which allow for the employer to make his returns in fragments using either or both of the electronic transmission routes, and changes to allow very large employers to use the internet service by compression of messages. The need for these facilities was first raised in employer consultation late in 2002;
  - Inland Revenue will accept magnetic media returns as a fragment of a whole return even though these are not an allowable electronic transmission route under mandatory e-filing. This will provide additional flexibility to, for example, payroll bureaux providing services to smaller employers. Excluding magnetic media would make it difficult for payroll bureaux to continue to provide the services, in the short term, which best suit their customers' needs.

## **9. Equity and Fairness**

44. During the Committee stage debate into Section 135 Finance Act 2002 the Government agreed that the Inland Revenue, when producing the final regulations, should look to accommodate the concerns of some 1,400 employers whose religious beliefs are incompatible with the use of electronic communications whether directly or indirectly via an intermediary. To leave these employers within the framework for a mandatory electronic return would have left them the choice of penalties or acting against their beliefs. Inland Revenue have met representatives of these employers and their concerns have been recognised in these regulations.
45. These employers will be able to continue to make their return on paper.
46. An employer who decides to use Electronic Data Interchange as the means of electronic communications, is likely to incur higher one-off setting up costs to put the infrastructure in place. However the decision to make the extra outlay will have been based upon the wider business benefits greater use of electronic communications will bring them. Medium sized employer (50+ employees) who use the Inland Revenue PAYE Online for Employers Services to meet the mandatory submission of the Employer Annual Return requirements, without any appreciable outlay, would achieve few of the other benefits of doing business with Inland Revenue electronically. They would also not achieve any of the benefits that wider use of new technologies bring.
47. Within the requirements and timetable of mandatory e-filing, employers will have choice over which areas of business to conduct electronically, and if so, how. Within that flexibility, employers may want to undertake some cost/benefit analysis to determine which is the most business efficient way forward for them.

## **10. Securing Compliance**

48. The Inland Revenue has set up a special programme to ensure that all employers know when they must file their end of year PAYE returns electronically. The advantages to the employer (including financial incentives for employers with fewer than 50 staff who file sooner than they are required to) are being emphasised, and essential information is being provided to help employers decide what method of e-filing is best for them. Many may find that using a payroll bureau could be beneficial.
49. The Inland Revenue has also started a recruitment campaign. All employers will receive information through inserts in the annual employers' pack, mailshots etc. There will also be open invitations to Employer Talks and events, payroll conferences and local events organised in partnership with Chambers of Commerce and others where Inland Revenue speakers will explain the statutory requirement and when practical steps need to be taken. Dedicated Inland Revenue teams will make individual contact with those employers impacted first by compulsion (including government departments, local authorities, the NHS and those who currently use magnetic media) to explain their statutory requirements and offer support. Recruitment teams have now been established in every region to look after other employers.
50. Medium and large employers who fail to file electronically will incur a penalty which is based upon the number of 'employee summary details' (P14 data) they submit with the maximum penalty being £3,000p.a. Employers will therefore be encouraged to e-

file in order to avoid the imposition of a penalty. This new penalty will be in addition to the penalty which is levied when an employer return is submitted late.

51. Employer electronic returns will have to meet the Quality Standard in order for the return to be accepted by the Inland Revenue and the incentive to be paid to small employers. Electronic returns which do not achieve this requirement will be returned to the submitter for correction. The introduction of the Quality Standard and improved test services is expected to improve the quality of employer returns and the move to the use of new technologies will improve the accuracy of day to day payroll calculations.

## **11. Impact on Small Businesses**

52. Employers with less than 50 employees who file their returns on-line to the Quality Standard will be entitled to the incentive irrespective of whether the services of an intermediary were used or not. The Government has set aside £420million for this over the 5 years from 2005.
53. In respect of employers with between 50 and 249 employees, the case studies have been discussed with employer representatives whose main concern was the cost of action following on from using Inland Revenue's Works Number Update facility. (Works Number Update is a process which updates the Revenue record in line with the employer's record.)
54. The extension, for a further year, of the 100% first-year capital allowances for information and communication technology, will also help businesses to meet the costs of IT hardware
55. In its continued efforts to support the small employer improvements have been made to the content and search facilities in the Employer Annual Pack CD-ROM and this will shortly be coupled with the improved Inland Revenue website which contains various calculator facilities all of which support the greater use of IT and moves towards a paperless environment.
56. The Small Business Service, who also organised workshops with small employers, were pleased to be involved in the development of this regulation from an early stage, and are content that many of the improvements they helped to identify have been incorporated in the final proposals.

## **12. Impact on Competition**

57. It is anticipated that the overall measure increases the amount of competition somewhat in both the retail payroll software and intermediary markets. This is due to the rapid need for employers to obtain software products or services which meet the new statutory requirements to electronically file in accordance with the Quality Standard.
58. A competition filter test has been applied and identified two specific markets which are impacted by these regulations:
  - payroll software providers;
  - payroll bureaux, intermediaries and service providers;

both of which are expected to benefit from a very significant increase in their customer base. Each sector has a wide range of providers of both general payroll services and a smaller market for more specialised areas such as General Practitioners or domestic staff. Additionally it is anticipated there will be new end of year filing products/ services which are not actually payroll software but meet the demands of the market. New players in the market should not experience high set-up or on-going costs as a result of these regulations. At present three major players in each sector collectively account for less than 50% of the market although there is one software provider which currently holds about a third of the of the payroll software providers' market share. Many software and service providers are actively e-enabling their products in readiness for these regulations and Inland Revenue are regularly communicating (via Inland Revenue Notes for Payroll Software Developers) with the balance.

59. All employers are affected by these regulations. Whilst the precise impact is dependent upon the employer size neither the amount of the incentive payment over 5 years (£825) nor the costs of obtaining e-filing facilities are likely to put one employer at a greater advantage in the market place over another of similar size.

### **13. Monitoring and evaluation/review**

60. The introduction of these regulations will be monitored against the relevant published Public Services Agreement targets which are:
- deliver year on year improvements in the number of individuals and businesses who comply with their obligations and receive their entitlements;
  - in 2007 compare e and non e rates of filing employer returns on time. If electronic returns are more likely to be late, investigate the cause and make recommendations of remedial action as necessary;
  - deliver year on year reductions in compliance costs that act as a barrier to the establishment and growth of small businesses.
61. In 2007, when the medium employers have made two returns electronically, update the cost/benefit analysis for the medium and large employer segments.
62. Additionally take a sample of small employers who have voluntarily moved to electronic filing and update and compare their cost/benefit analysis;
- Improve take up rates for services offered electronically.
63. Compare performance against e take-up targets which are:
- 45% of employee summary details for the year 2004/05 to be filed electronically in 2005/06;
  - 55% of employee summary details for the year 2005/06 to be filed electronically in 2006/07;
  - where targets are not met, investigate and make recommendations accordingly.
64. Improve value for money by achieving annual productivity gains of at least 2.5% per year without detriment to accuracy or customer satisfaction.

65. In 2007 examine Inland Revenue's savings against the those published in this assessment by evaluating the amount of clean data received and measuring the number of non matching items that have not immediately posted to individual PAYE and National Insurance records.
66. This project has a 5 year cycle enabling the results of these evaluation exercises to be fed back into the project and where appropriate remedial action taken before the end date.

#### **14. Consultation**

67. The following additional Government Departments have been consulted:
  - Inland Revenue has undertaken capacity planning and dynamic business modelling of the electronic services, including interfaces with the Government Gateway, to ensure that the capacity of the infrastructure is sufficient as e-filing increases between 2003 and 2010. This work will be repeated in future years to re-validate the results and ensure on-going resilience and capacity.
68. We have also consulted on 8 separate occasions with:
  - Employer representative bodies;
  - Accountancy and professional bodies;
  - Representatives of the payroll software industry, intermediaries and end users.
69. The main thrust of their concerns were linked to operational matters and were:
  - The need to address the difficulties large employers and intermediaries would face if both components (P35 and P14 Data) of the end of year return had to be submitted together from a single source and by the same electronic means. The Government has agreed there is a need to enable employers to continue to enjoy the flexibility allowed at present to file these components separately. Failure to provide this facility would require large employers and intermediaries to undertake a significant reorganisation of their services which would be disruptive to both them and employers. As a consequence both Inland Revenue and employer/intermediary IT systems will be built to allow submission of and receive returns in fragments that will be checked against the Quality Standard and held until the balance of the return is received and validated. All fragments must be received and fully validated by the relevant due date in order for the employer to avoid a late filing penalty.
  - The regulations require that specified persons are notified of their responsibilities to file electronically. Representatives highlighted the need for these new notifications to be issued at a time of year when payroll is potentially at it slackest whilst at the same time, allow sufficient time for employers to make a positive response and introduce the necessary changes into their payroll processes before the start of the relevant financial year. The Inland Revenue has been able to meet these concerns. The precise date of these notifications will be set out in Board's Directions but will be before 30 November and the notices will be issued

before 31 December each year. At the same time these notices to employers will also tell large employers of their responsibility to pay by electronic means<sup>4</sup>.

- Mandatory electronic filing proposals include a requirement that the employer return is of the necessary quality. Consultation has focused on the specific requirements in order to minimise the impact these validations will have on employer's day to day payroll processes. This was coupled with the need for Inland Revenue to make a timely response to electronic returns and provide clear, concise messages when a return is not of the required quality in order that the submitter can undertake remedial work and resubmit the return before the due date. The Quality Standard, which will apply for 2004/05, was published in April 2003 following consultation with employer representative bodies and payroll software developers.
- In response to employer demands test services will be provided as follows:
  - quarter 4 2003 Inland Revenue will extend the existing internet test services to include the 2004/05 Quality Standard validations;
  - Summer 2004 Inland Revenue will provide a richer test service which replicates the new April 2005 infrastructure;
  - Early 2005 Inland Revenue will provide a test service in the live environment.
- Inland Revenue have undertaken a separate major consultation with groups of employers in order to understand customers' issues with operating a payroll, and what improvements they would like to see. Their views will be taken into account in reshaping the way PAYE works for customers. Inland Revenue has also consulted employer representatives about the nature and timing of communications to employers. Representatives' input has been taken into account in text for *Employer's Bulletin* and *Tax Bulletin* articles prior to publication, and on guidance material.
- Employer correspondence received since the April 2002 Chancellor's Budget announcement has concentrated on the practicalities of e-filing or claiming the incentive. Large and medium employers are already more likely to be using payroll software and have generally not queried the imposition of legislation. There has been some concern about broadband coverage in rural areas.
- There has been some concerns that Magnetic Media will not be accepted as an electronic transmission route. Existing Magnetic Media users would like to be spared the initial setting up costs of moving to acceptable electronic transmission routes. However there is a delay in any form of non-electronic transmission which is exacerbated when the return has to be rejected, and then resubmitted, especially when there are postal failures. Historically Magnetic Media has a higher error rate than either EDI or internet transmissions. As shown in para 9.1 above, it is important for employees and pension providers to have speedy access to the data. The quick acknowledgements of the e-return takes away the significant uncertainties about whether the full return has been received, a problem which has traditionally caused well-meaning employers and Inland

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<sup>4</sup> Regulations – The Income Tax (Employments) (Amendment) Regulations 2003  
Regulatory Impact Assessment – Mandatory Electronic Payment by Large Employers

Revenue much unproductive work whilst at the same time has allowed others to escape the consequences of their delays.

- Consideration was given to the option to pay the incentive direct to accredited intermediaries who handle payroll matters on the employer's behalf. To make payments direct to intermediaries would not have guaranteed that the value of the incentive would be passed to employers. To introduce an accreditation process had the potential to lead to a limited range of services being provided at an increased cost. The process of inserting the Inland Revenue (or some other accreditation body) could delay the developments of a wider-ranging and more competitive intermediary market. To avoid these difficulties, and the technical problems where more than one intermediary acts, the issues were discussed with employer representative bodies and the option rejected. All incentive payments will be paid to the employer and the Inland Revenue will not seek to accredit the services provided by an intermediary. Instead reliance will be placed upon the Inland Revenue Payroll Standard accreditation service which checks the accuracy of calculations in payroll software and ensures that the software complies with the requirements of the Quality Standard.
- In response to a specific request from the Brethren the exclusion from the e-filing requirement has been extended to include Brethren Companies (companies owned and run by members of the Brethren and companies where all the directors and the company secretary are members of the Brethren). However, in order not to create an opportunity for avoidance of these regulations, that exclusion will not be extended to non-Brethren clients of Brethren tax practitioners.

## **15. Summary**

70. This impact appraisal addresses specific regulations and Board's Directions about mandatory e-filing. The costs and benefits – whether to employers, payroll intermediaries or the Inland Revenue – of these regulations are difficult to separate from the much wider set of process improvements. In isolation, a simplistic cost-benefit analysis of the regulations shows no return in purely financial terms. But the regulations put the Inland Revenue into a position to undertake wider process and organisational change.
71. For the largest employers the benefits of these specific regulations may be small when taken in isolation, but the longer term benefits from wider use of new technologies in the round will be easier to achieve from the economies of scale and investment both during the financial year as well as at the year end.
72. The medium sized employer with 50 to 250 (and possibly higher) is likely to see overall benefits fairly quickly from the quality standard and internet transmission, especially those who switch to an up-to-date integrated software package.
73. For employers of less than 50 employees, these regulations do not impose mandatory e-filing. Instead, they make available some £420 million of public funds for voluntary e-filing.
74. It is expected that by looking across the range of employers, with 50 or more employees, the compliance benefits are broadly in balance with the compliance costs estimated for the first seven years.

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**REGULATORY IMPACT ASSESSMENT**

**Payroll Services (Electronic End of Year Filing of Employer Returns)**

**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:

A handwritten signature in black ink, appearing to read "Dawn Thomas". The signature is fluid and cursive, with a large initial "D" and "T".

Date 24/9/03