REGULATORY IMPACT ASSESSMENT

NATIONAL INSURANCE CONTRIBUTIONS

Extension of Class 1A National Insurance Contributions (NICs) to all taxable benefits in kind not subject to Class 1 NICs

Introduction

1. Currently some benefits in kind (BIKs), such as readily convertible assets, are within Class 1 National Insurance Contributions (NICs) whilst employer provided cars and fuel for private use (the most widely provided benefits) are within Class 1A NICs. But there continues to be some BIKs which are subject to tax but not NICs. The Taylor report, which considered tax and benefits reform, recommended that the differences in the treatment of BIKs be removed in the interests of Tax/NICs alignment.

2. In the 1999 Budget, the Chancellor announced his intention to align the treatment of BIKs for employers' National Insurance and income tax. This means the extension of Class 1A NICs charge from April 2000 to all taxable BIKs, not included in a PAYE Settlement Agreement, and which are not currently subject to NICs.

3. The extended Class 1A BIKs will relate to benefits provided in the tax year 2000/2001 and the first payment will be due in July 2001.

Issues and objectives

4. The extended Class 1A NICs charge will bring greater equality of treatment between the cash and non-cash earnings. Bringing taxable BIKs (not already subject to NICs) into Class 1A NICs is a further step towards tax and NICs alignment.

5. The assessment below concerns the costs and benefits to business of complying with the new rules. The extra Class 1A NICs revenue from this provision is estimated at £225m post-behaviour in 2000/01.

6. Alongside the extension of Class 1A, to counter potential avoidance it is necessary to put beyond doubt liability for Class 1 NICs in certain circumstances. Regulations, to be made after Royal Assent, will provide that Class 1 NICs shall be paid on the purchase of a benefit made by the employee supposedly on behalf of the employer, but actually purely for personal gain. The most common example encountered is an employer allowing an employee to use a company credit card to make private purchases.

Risk Assessment

7. If the proposal to charge Class 1A NICs on all taxable BIKs is not implemented there will be a continued incentive for employers to remunerate employees in a non-cash form, resulting in a loss to the NI Fund. Not levying NICs on benefits means NIC rates elsewhere in the NICs system have to be higher.

8. It is necessary to put beyond doubt liability for Class 1 NICs in prescribed circumstances, to avoid transactions being arranged so that only Class 1A NICs is paid, where Class 1 NICs should be paid.

Options

9. The key options are summarised below.

- *Do nothing.* Employers have the right to arrange remuneration packages for their employees in the most efficient manner for NICs. However, the existing NICs structure is distortionary in its effect – by providing financial advantage with respect to possibly otherwise inefficient forms of remuneration. Bringing greater equity between cash and non-cash earnings for NICs will make the NICs scheme fairer and reduce the distortionary financial incentive for employers to offer remuneration packages which include substantial non-cash items.

- *Bring taxable BIKs not currently subject to NICs into Class 1 NICs liability.* This would eliminate the distortion but would involve employers having to account for NICs on benefits in the pay period in which they were provided. Given the difficulty associated with valuing benefits and the fact that, for tax purposes, benefits are reported on an annual basis, this would result in a substantial increase in administrative burden on business.

- The recommended option which was announced by the Chancellor in the 1999 Budget – *Extend the Class 1A NICs liability to all taxable BIKs not subject to NICs*. The annual nature of Class 1A NICs overcomes the difficulty of having to value benefits in the pay period and allows the details of benefits already reported annually by employers for tax on their P11D returns to be used as a basis for calculating the Class 1A NICs liability. There is no employee charge and no impact on future benefit entitlement.

Benefits

10. The benefits of the proposed measure are:-

- It will protect the National Insurance Fund from a loss of revenue. It is estimated that the additional revenue to the National Insurance Fund for 2000/2001 will be £225 million. This costing is presented on the new National Accounts basis, which aims to recognise tax/NICs when the liability accrues irrespective of when the amount is paid to exchequer;

- It will bring greater equity between cash and non-cash earnings, reducing the distortion which provides the incentive for employers to remunerate their employees with benefits rather than cash earnings to avoid NICs. (In administrative terms cash, or cash equivalents, will nearly always be the most efficient form of remuneration but by providing a financial advantage with respect to non-cash remuneration the existing NICs structure can distort the business decision with respect to remuneration);

- It will introduce greater fairness between large employers and smaller employers less able to provide sophisticated benefits packages to take advantage of the distortion in the existing NICs structure;

- The planned new payment and collection method means some employers who currently account for Class 1A on cars and fuel with PAYE may experience the benefit of reduced recording requirements year on year;

- The planned new payment and collection method should result in better compliance. It will also mean interest will be able to be applied on late payment of Class 1A more effectively. It will remove the 9 month “interest holiday” on Class 1A paid via PAYE.

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Behavioural effects

11. The loss of NICs yield from behaviour under this measure is likely to be very limited: we estimate around £5 million. The behavioural yield loss is small because the extension of Class 1A NICs to all BIKs leaves little scope for avoiding the new charge altogether. Some employers may decide to stop providing certain existing BIKs without granting commensurate increases in salaries, but the numbers doing so are likely to be small. Other employers may retain provision of benefits-in-kind while seek to pass on part of the new charge to employees via downward adjustments to salaries. Again, however, this effect is likely to be very small.

Compliance Costs

<u>Business sectors affected</u>

12. It is estimated the extension of Class 1A to all BIKs will result in around 290,000 employers having a liability for Class 1A on benefits provided to their employees. Currently around 240,000 employers pay Class 1A NICs on cars and fuel benefits with just over half of these also providing at least one of the other BIKs that will become subject to a Class 1A NICs charge from April 2000. The extension of Class 1A to all BIKs will mean that an estimated 50,000 more employers (who provide other BIKs but not cars) will pay some Class 1A NICs on BIKs for the first time.

13. The size distribution of employers who will be liable to pay Class 1A after the extension to all BIKs is given in table 1 below.

		Employers who will be affected by the extended Class 1A NICs charge	
Employer size	***Employers who provide cars and fuel only***	***Employers who provide cars, fuel and other benefits[1]***	***Employers who provide benefits[2] but not cars and fuel***
Small (1 to 4)	*53,100*	*24,100*	*26,500*
Small (5 to 10)	*26,300*	*26,800*	*11,000*
Small(11 to 100)	*26,600*	*57,600*	*9,800*
Medium (101 to 500)	*1,600*	*10,800*	*1,000*
Large 500+	*600*	*3,300*	*300*
Unknown size	*4,400*	*3,500*	*3,300*
Totals	*112,600*	*126,100*	*51,900*

Notes

1. Employers who provide cars, fuel and other BIKs that will become subject to a Class 1A NICs charge from April 2000
2. Employers who provide other BIKs that will become subject to a Class 1A NICs charge from April 2000

14. The wholesale and retail trade, business services (inc legal, accounting, consultancy services etc.) and manufacturing sectors are the industry sectors where the provision of benefits that are going to be subject to a Class 1A NICs charge tend to be more common. As a consequence these sectors are going to be most affected by the extended Class 1A NICs charge with an estimated 70% of employers who will pay Class 1A NICs following the extension, being within these sectors. The business sectors least affected by the Class 1A NICs extension are mining and quarrying, agriculture, electricity, gas and water supply, public administration and defence, education, health/social work and the hotel and restaurant industry.

Factors affecting costs

15. Compliance costs are divided into non-recurrent set-up costs and costs which occur year on year.

16. The compliance costs that employers who provide benefits will face as a result of the extension of the Class 1A charge to all BIKs will depend on

- the number of employees to whom they provide benefits;
- the extent of the benefit packages provided;
- whether they use manual or computerised P11D systems;
- whether they pay their Class 1A using the PAYE system or the Alternative Payment Method (APM).

17. By far the most commonly provided benefits are car and fuel benefits which are already within Class 1A NICs liability. Private medical and dental benefits are the next most common provided benefit, with an estimated 120,000 employers providing this benefit to 2.1 million employees. Employers do not provide other benefits on anything near the same scale as the car and medical insurance benefits, but of the other benefits provided the main ones are

- **Vans** — **Provided by 36,400 employers to 195,000 employees**
- **Beneficial loans** — **Provided by 13,700 employers to 129,000 employees**
- **Accommodation.** — **Provided by 10,000 employers to 37,000 employees**

18. Some 113,000 employers only provide cars and fuel to their employees and therefore are going to experience relatively little change in their compliance costs. In the first year there may be some costs associated with determining that they are relatively unaffected by the new rules and perhaps some recurrent savings resulting from the planned redesigned payment and recording method.

Set-up costs

19. Non-recurrent set-up costs will depend mainly on whether the employer is new to paying Class 1A and whether a manual or computerised P11D system is used.

20. Employers who provide taxable benefits will have either to read guidance to familiarise themselves with the new rules or alternatively buy in advice or assistance. The extent to which this will be required will depend on whether or not the employer currently pays Class 1A and whether they just provide cars and fuel.

Type of employer	**Estimated time to become familiar with the new rules**
Employers who do not provide benefits	Time needed to determine that the new rules will not apply to them estimated at 1hr per employer
Employers who provide cars and fuel only	Time needed to determine that they will be relatively unaffected by the new rules other than completing the new P11D(b) and using the planned new payment method estimated at 1hr per employer.
Employers who provide cars, fuel and those benefits that will become subject to a Class 1A charge from April 2000	Time will be needed to determine the scope of the extended Class 1A charge and will be affected by the range of benefits other than cars provided. Time will also be needed to familiarise with the new P11D(b) and the planned new payment method. Estimated at 3 hrs
Employers brought into Class 1A NICs for the first time	Time will be needed to familiarise with the new charge and the reporting and payment requirements. Time will be affected by the range of benefits provided. Estimated at 6 hrs

NB: Timings for typical sole-trader/owner of company employing a small number of employees and doing the work in person.

21. If employers choose to buy in advice or assistance to deal with their NICs affairs, the extension of Class 1A NICs to all BIKs is likely to increase the amount of advisers' time needed. This will be a recurrent cost, which will depend on the extent of the benefit package provided by the employer.

22. If an employer has a computerised P11D system, computer software revisions will be required in the first year in order for the Class 1A NICs to be calculated automatically. This will be most likely where an employer, particularly a large employer, has a bespoke computer system. The more sophisticated off the shelf software packages, are likely to be enhanced to take account of the Class 1A NICs changes with this reflected in the cost of the software licence/contract.

23. There will be no significant change to the data it is necessary to enter onto the P11D. Therefore, it may be viable, particularly where an employer has a relatively small number of employees and range of benefits provided is relatively small, for the employer to forego any systems changes and just continue to use the existing P11D print out. The employer could then calculate the Class 1A manually from the print out.

Recurrent costs

24. The recurrent costs/savings will depend on the number of employees, the range of benefits provided, whether they use manual or computerised P11D systems and whether they pay their Class 1A currently using the PAYE system or the APM.

Recording

25. Employers already need to report BIKs provided to employees for tax purposes using P11Ds and P9Ds. A P11D is only used to record the benefits provided to directors or employees with earnings above £8,500 (including BIKs) whilst a P9D is used to report benefits provided to very low earners. So, to limit compliance burdens on employers, Class 1A NICs will only be payable in respect to directors and employees with earnings above £8,500 (including BIKs). This means that employers who only have to report benefits provided to their employees on a P9D for tax purposes will not be affected by the extension of Class 1A NICs.

26. Employers who provide benefits to directors or employees with earnings above £8,500 (including BIKs), will use the valuation figures recorded on P11Ds to calculate the Class 1A NICs charge.

27. The existing P11D and P11D(b) are to be revised slightly to make it easier to calculate the Class 1A NICs. The revised P11D will use colour coding and text identifiers to indicate which figures (already entered for tax purposes) are to be used to calculate the Class 1A NICs. Employers will total the appropriate P11D figures in respect to each of their employees to reach a total which will be recorded on the revised P11D(b) employers declaration. This total will then be multiplied by the Class 1A rate to determine the amount of Class 1A NICs payable. The employer will then have to complete a payment slip and send this along with a cheque to the Collector by 19th July (although a separate payment slip will be required, the employer may choose to send one cheque covering the Class 1A payment and his normal monthly PAYE payment). The return date for the P11D and P11D(b) will remain as 6th July and the date by which the Class 1A NICs must be paid will remain as 19th July.

28. There should be little additional work for the employer in recording the figures on the P11D, as these are already required for tax. However, as the different items recorded on the P11D will be treated in different ways (some attracting a Class 1A charge), employers will have to be more rigorous in ensuring that benefits are being recorded correctly. Employers are likely to have to refer to guidance more than they did in the past, particularly in the first year.

29. The planned revised P11D(b) will have the facility for adjusting the total benefits shown as liable to Class 1A NICs on the P11D forms. This provides some flexibility to the employer, where their particular practice of reporting benefits means that basing the Class 1A calculation strictly on the P11D figures would give an incorrect result.

30. The main area of additional work will arise in totalling the benefits subject to Class 1A from the individuals' P11Ds in order to calculate the Class 1A NICs completing payable and the revised P11D(b).

31. Employers provide their employees with copies of P11D information for their use in completion of their self assessment returns. Employers may have to answer questions raised by their employees resulting from the slightly altered P11D format. However, this is unlikely to be a significant burden.

Payment and collection method

32. Currently two systems of payment and recording for Class 1A on company cars and fuel exist, the alternative payment method ((APM) paying direct to the Inland Revenue National Insurance Contribution Office) and PAYE system. It is estimated that 46,000 employers currently pay their Class 1A using the APM whilst approximately 200,000 employers use the PAYE system.

33. Just one payment system will be available to employers from July 2001. Payment with PAYE will no longer be available, but the proposed new system of payment and recording is being designed along the lines of the APM, with minimum recording requirements (i.e. at present the employer is only required to send with the Class 1A NICs payment a return giving the number of cars to which the payment relates).

34. This payment method was selected because feedback from employers representatives indicated that they found payment through APM more straight forward than with PAYE. The process for paying Class 1A NICs via PAYE involves an employer including payment of their Class 1A NICs along with their normal month 3 PAYE payment by the 19th of July. The Class 1A payment made in respect of each employee then needs to be recorded on the employees' P11 deduction working sheet and shown as category Y contributions. At the end of the tax year, the employer needs to record the Class 1A payment in respect of each individual employee on the P14 and again show this as category Y contributions. The employer will at the same time be required to record the payment in respect of each individual on the P35 summary return in the column employer's secondary national insurance. This requires the employer to add the Class 1A payment in respect of each employee to the secondary Class 1 NICs payment for that employee.

35. As a result of the new recording and payment method for the extended Class 1A, some employers who pay Class 1A NICs using the PAYE system and have a manual payroll may experience some administrative savings using the new recording and payment method. This will be less apparent for employers with automated computer payrolls.

Reporting for tax

36. To ease the introduction of the extended Class 1A NICs charge it is intended that there will be some changes to the tax rules which should reduce employer's reporting requirements.

37. An existing rule exempts from income tax equipment and services used on the employer's premises solely to carry out the duties of the employment. It is proposed that this exemption should be widened to allow some small amount of non-work use and also cover benefits (excluding certain luxury items) supplied by the employer for use outside the workplace, on condition that they are provided for the purpose of the employment and used primarily for that purpose.

38. These relaxations will mean that where the private use of the benefit is insignificant, employers will no longer be required to report it on the P11D. It will also mean that employees will no longer have to make a claim for a deduction for the business use element of these items on their self-assessment form.

39. Another deregulatory tax measure to ease the position for employers in the context of the extension of Class 1A NICs is to exempt the reporting of those beneficial loans – loans from employer to employee at no or at a low rate of interest - where the interest payable (or treated as payable) wholly qualifies for tax relief.

40. The Revenue will be consulting with employer representatives on the extent to which these measures will reduce record keeping burdens and produce compliance savings for employers.

Reporting for Class 1 NICs

41. Class 1 NICs liability will arise on the purchase of a benefit made by the employee supposedly on behalf of the employer, but actually for purely personal gain. The most common example encountered is an employer allowing an employee to use a company credit card to make private purchases.

42. Employers who allow employees to use company credit cards to purchase goods and services for private use, will in the future have to establish when a credit card has been used during the pay period and determine whether the amount concerned needs to be added to gross pay for Class 1 NICs purposes.

43. This will not apply where the company credit card is used only to cover business expenses.

44. From information available it is not possible to reliably estimate the number of employers who provide company credit cards to employees for private as well as business use or the number of employees who have such facilities made available to them. This makes estimating the number of transactions that will have to be added to gross pay for Class 1 NICs purposes difficult.

45. Consultation with employer representatives has indicated that operating Class 1 NICs on credit card purchases for non-business use will apply a significant compliance burden in the cases of some employers. Indications are that company credit cards tend to be made available in the main to company directors and senior executives, and are particularly used within small close companies, comprising of a couple of company directors and a few employees.

46. In some companies there is tight control on company credit card use and the company policy is that their use should be limited to business expenses. In these

cases employers should experience no additional compliance cost as a result of the regulations.

47. Employer representatives raised the fact that control of credit card use in some organisations would be divorced from payroll, therefore making information flows between departments necessary. This is likely to be more of an issue within a larger company, with perhaps a large sales force who have use of credit cards, than within a small close company. The compliance issue was however considered magnified by the fact that accounting for NICs on credit card purchases would have to be done on a pay period basis. Employer representatives felt the impact of the Class 1 NICs liability was likely to cause behavioural change in the area of credit card use within companies.

48. Information is not available to enable us to estimate with any degree of certainty, what the potential compliance cost of this provision will be. However, the main employers affected will be those who allow company credit cards to be used by employees for purely personal gain.

Compliance costs for a typical small employer with 1 to 4 employees

49. There are around 670,000 employers (size 1 to 4 employees) in the UK. Of these we estimate 24,100 (3.6%) provide cars, fuel and other benefits that will become subject to a Class 1A NICs charge and are therefore currently paying Class 1A NICs, but from April 2000 will be liable to pay Class 1A NICs on an extended range of benefits. We estimate that 26,500 (4.0%) of small employers will be brought into Class 1A NICs liability for the first time, whilst 53,100 (7.9%) small employers will continue to pay Class 1A NICs on cars and fuel as they do currently. Employers who currently pay Class 1A NICs on cars and fuel are likely to have different compliance costs resulting from the extended Class 1A NICs charge compared to small employers paying Class 1A NICs for the first time.

50. Employers of this size use manual systems in 37.5% of cases, advisers in 37.5% of cases and PC software in 25% of cases.

51. In order to consider the likely compliance costs of a small employer from the extended Class 1A charge it is necessary to make some broad assumptions. It is recognised that the two typical small employer examples shown below would be affected particularly if the assumptions were changed and instead it was assumed that a computerised payroll was used or that advisers completed the P11D process and calculated Class 1A NICs liability on the employers behalf. The size of the range of benefits provided by the small employer would also have an effect on the compliance costs incurred. An employer providing a wide range of benefits will need to take more care when recording entries on the P11D and more time will be involved in totalling the P11D figures at the year end.

52. Typical small employer – 2 directors and 2 employees using a manual payroll:

53. Company A - Has two cars and provides medical insurance for the 2 directors and the 2 employees. All earn more than £8,500 per year. This company has previously paid Class 1A NICs on the two company cars using the PAYE system.

54. Company B – Provides medical insurance for the 2 directors and the 2 employees. All earn more than £8,500 per year. From April 2000 this company will be liable to pay Class 1A for the first time.

Tasks	**Compliance costs resulting from the extension of Class 1A NICs – typical employer timings & costs**	
	Company A	**Company B**
Non recurrent	Time will be needed to determine the scope of the extended Class 1A charge and that Class 1A will now have to be paid in respect to the medical insurance for the 4 employees as well as the 2 cars provided. Time will also be needed to familiarise with the new P11D(b) and the planned new payment method. Estimated time 3 hrs Estimated cost £60	Time will be needed to familiarise with the new charge and determine that Class 1A will now have to be paid in respect to the medical insurance for the 4 employees. Time will also be needed to familiarise with the reporting and payment requirements for Class 1A. Estimated time 6 hrs Estimated cost £120
Recurrent	Needs to add together the value of the medical insurance benefits and car benefits reported on each employee's P11D and record this on the revised P11D(b) employers declaration, then multiply this by the Class 1A rate to determine the amount of Class 1A NICs payable. A payment slip will need to be completed and sent with a cheque to the Collector. The employer will no longer have to record on the P11 deduction working sheet of the two employees with cars the amount of Class 1A paid as category Y contributions. Employers will also no longer, at the end of the tax year, need to record the Class 1A payment in respect of the 2 employees on their P14 or the P35. It is considered that the additional time taken to calculated the extended Class 1A NICs charge is likely to be 5 minutes say £2. Add on a similar amount for overheads. No extra cheques are required. Therefore the total estimated recurring cost is £4 per year.	Needs to add together the value of the medical insurance benefits reported on each employee's P11D and record this on the revised P11D(b) employers declaration, then multiply this by the Class 1A rate to determine the amount of Class 1A NICs payable. A payment slip will need to be completed and sent with a cheque to the Collector. Estimated time 20 minutes. Estimated cost say £7. A cheque is required, say £5 full cost. Allow a small amount for overheads, say £3. Therefore the total estimated recurring cost is £15 per year.
Total costs per company	£60 in first year	£120 in first year
Multiply by Number of employers affected Total costs for small existing and new employers	x (number of micro) @ £4 per year recurrent plus some ad hoc adjustments for the unknown size, new and unaffected employers.	x (number of micro) @ £15 per year recurrent plus some ad hoc adjustments for the unknown size, new and unaffected employers.

NB Similar methodology applies to employers that are larger than 1 to 4 employees where the manual system is progressively replaced by a full software support.

Total compliance costs

55. The total compliance costs for all the employer sizes, including some allowance for those not directly affected follows by extending the methodology and timings from the micro employers to the rest of the employers in para 13. The unknown size employers are assumed to be effectively all micro size.

56. The one-off cost of the measure is estimated to be about £20 million in round terms. The micro employers share of this is around 30%. Employers of size 5 to 99 account for around a further 40%.

57. The total recurrent costs are estimated to be about £2.5 million per year. This assumes that the bulk of the medium and large (including all government) payrolls invest in a software upgrade to handle the change as cheaply as possible. The affected micro employers account for about a quarter of the recurrent costs.

Small business 'litmus test'

58. The small business litmus test is covered by the above analysis. That is, a typical small employer faces an average £4 to £15 per year increase in recurrent compliance costs and an average £60 to £120 one-off compliance cost in the first year.

59. The Bath Report estimated that the total PAYE/NICs compliance costs are on average around £800 per year (adjusted to 2000 prices) for a micro employer (1 to 4 employees). Thus, the £4 to £15 average increase for an affected employer due to the extended Class 1A NICs charge is about 0.5% to 2% of the total average compliance cost before other changes not considered by Bath (eg Working Families Tax Credit). This is before adjustment for the one-off costs.

Other costs, including enforcement monitoring and review

60. Through its established programme of compliance surveys, the Inland Revenue will monitor employers' compliance with the new measure.

Data sources

61. Estimates of Class 1A NICs yield, numbers of employees and employers affected arising from the Class 1A NICs extension, are based on the 1997/98 Revenue's Employer Compliance data base, which has been projected forward to 2000/01.

Results of consultation

62. The general approach to the assessment of compliance costs for the purposes of this RIA are based on consultation with employer representatives serving on the Revenue's employer consultative group. These include the Institute of Directors, the Institute of Payroll and Pensions, the Confederation of British Industry and a number of tax and accountancy bodies.

Summary and recommendations

63. This measure will bring greater equity between cash and non cash earnings, reducing the incentive for employers to provide their employees with benefits rather than cash earnings. It is estimated that this measure will bring an estimated £225 million additional revenue to the National Insurance Fund for 2000/01. Employers will face a one-off cost of £20 million in respect of 2000/01, the first year of the scheme, and no one-off costs thereafter. Employers' ongoing costs for subsequent years are estimated at £2.5 million.

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