

Basic Payroll - PAYE Tax and NICs 2006/07

Published by:

HRD & Payroll Solutions

39 High Street, Banbury, Oxon, OX16 5ET

Telephone: 01295 22 55 00 Fax: 01295 268973

E-mail: info@hrdps.co.uk

Web Site: www.hrdps.co.uk

© HRD & Payroll Solutions, May 2006

Basic Payroll - PAYE Tax and NICs

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means, electronic, mechanical, photocopying, recording or otherwise, without prior written permission of the publishers.

While every care has been taken in the accuracy of the compilation of these course notes, the text is for guidance only. No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the publishers and arrangers of this course. The material contained does not affect any right of appeal on matters about a taxpayer's own tax liability.

In line with ISO 9001:2000, this is an uncontrolled document and, although current at the time of issue will not be updated.

Ref: PNB060501v12

Contents

1. Overview of PAYE and NICs5
Basic concepts5
History.....6
Employer responsibilities7
Gross to net example7
Documentation and support8
 Glossary of terms11

1. Overview of PAYE and NICs

Basic concepts

1. The earnings of all employees in the UK are subject to deductions for income tax and National Insurance Contributions (NICs) from their wages. Employers must follow precise statutory rules in order to calculate accurately the amounts of income tax and NICs due. The method of calculating income tax liability is known as “Pay As You Earn” (PAYE).
2. There are a number of different classes of NICs. Unless otherwise stated, the abbreviation “NICs” always refers in these course notes to Class 1 NICs that are collected through the payroll. See **Error! Reference source not found.** on page **Error! Bookmark not defined.**
3. Employers may choose to operate the collection of PAYE income tax and NICs in-house, cared for by their own payroll person or department, or to outsource some or all of the function to a payroll service provider such as an accountant or payroll bureau. If the process is managed in-house, there are the further options of calculating PAYE manually or using a payroll software package. However, the responsibility in law for the collection, payment and reporting of PAYE always remains with the employer.
4. From 18 April 2005, the Inland Revenue, the Government tax department responsible for PAYE and NICs, merged with Customs & Excise to become Her Majesty’s Revenue and Customs (HMRC). In these course notes, the new department is called “HMRC”. Matters pertaining to NICs are cared for by the National Insurance Contributions Office (NICO) of HMRC.
5. Each employer is allocated to one of HMRC’s two Accounts Offices, in Shipley or Cumbernauld. Employers must send all of the income tax and NICs deducted from their employees’ earnings, together with their own NICs, to their Accounts Office. Payments must be made monthly or, in the case of smaller employers, quarterly.
6. Each employer is allocated to an office of HMRC, commonly called a “tax office” and may operate one or more PAYE schemes. For each scheme, HMRC provides
 - a PAYE reference that is used in all communication with the tax office and on statutory returns, and
 - an Accounts Office payment reference that is used when making payments of tax and NICs to HMRC.
7. Each tax office is linked to a computer centre, from which are issued instructions relating to individual employees.
8. The concept of PAYE is that an appropriate amount of income tax is deducted from pay each payday so that, by the end of the tax year (5 April each year), employees have paid their total tax liability for that year. PAYE, therefore, normally operates cumulatively, i.e. the tax due so far in the tax year is calculated on the employee’s cumulative earnings so far in the tax year. Employees are given an individual tax code, defining their “free pay”, i.e. the amount they may earn in the tax year before becoming liable for income tax.

Basic Payroll - PAYE Tax and NICs

9. Unlike PAYE income tax, the calculation of employer and employee NICs is not cumulative, although some special rules apply to directors. NICs are based on the employee's earnings in each pay period, rather than on the cumulative earnings in the tax year to date. However, there are multiple categories and rates to consider and, in this regard, NICs are more difficult to handle and the concepts harder to understand than PAYE. As with tax, each employee is allowed an amount of "free pay", i.e. an amount they may earn in each pay period before becoming liable for NICs. The rates at which NICs are deducted are determined according to each employee's "table letter", a code that reflects the employee's status for NICs purposes.

History

10. Income tax was first introduced in 1798 by William Pitt, to pay for the Napoleonic Wars. The five Schedules of income tax, including Schedule E for income from employment, were introduced in 1803. The tax survived a number of attempts to abolish it in the 19th century and, by the early part of the 20th century, there were about a million taxpayers. When it was to finance the war expenditure in 1945, the tax rates were increased and the starting threshold lowered, thereby bringing over 12 million workers into income tax.
11. PAYE was introduced in 1944 at a time when the working population was increasing in number and the problems of collecting tax each January and July was becoming increasingly difficult and expensive. The concept of PAYE, i.e. taking some tax from employees each time they are paid, has remained essentially the same for over 50 years.
12. NICs also started to be collected in the 1940s, to fund the social security payments due under the new welfare state plan. It was administered by the Contributions Agency. Initially, employers had to buy stamps to stick on each employee's card. From 1975, the administration was simplified and NICs became a percentage of earnings. In the 1960s, employees were able to save for a supplementary pension by making Graduated Pension contributions. This was replaced by the State Earnings Related Pension Scheme (SERPS) in 1978, offering an inflation-proof second pension and, at the same time, lower contracted-out rates were introduced for employees who are members of contracted-out occupational pension schemes. The Contributions Agency became part of HMRC from April 1999, and is known as the National Insurance Contributions Office (NICO).
13. Although the tax year in many countries matches the calendar year, the tax year in the UK runs from April 6 in one year to April 5 in the next. This situation originated in 1752, when the Gregorian calendar was introduced in Great Britain. The Julian calendar had been replaced in many European countries during the 16th and 17th centuries but, by the 18th century, the two calendars differed by 11 days. To bring Great Britain into line, the calendar was advanced by 11 days in 1752. The day following 2 September became 14 September, and the 3rd to the 13th of September simply did not exist! However, the Chancellor of the Exchequer at the time refused to shorten the tax year and the closing date for the government's annual accounts was extended by 11 days from 25 March (Lady Day) to 5 April, where it has remained ever since.

Employer responsibilities

14. In addition to the collection of PAYE income tax and NICs, employers are also responsible, as relevant, for
 - the collection of Student Loan deductions
 - the collection of tax on account from subcontractors in the Construction Industry.
 - the payment of Working Tax Credits
 - the payment of Statutory Sick Pay (SSP), Statutory Maternity Pay (SMP), Statutory Paternity Pay (SPP) and Statutory Adoption Pay (SAP).
15. Some or all of the payments of SSP, SMP, SPP, SAP and Tax Credits can be recovered from the government by deducting the amounts from the overall monies due for payment.
16. For details of the way in which the payments due to the Accounts Office are calculated, see **Error! Reference source not found.** on page **Error! Bookmark not defined.**
17. Payment is made to the Accounts Office monthly, or quarterly in the case of small employers. An employer is a small employer if the average payment due to the Accounts Office each month throughout the tax year does not exceed £1500.
18. Employers must keep proper records of all payments made to employees and the deductions made from those earnings. They must be accounted for annually by completing statutory returns after the end of each tax year. (See on page **Error! Bookmark not defined.**) Records must be kept for three full tax years beyond the current tax year and must be made available to HMRC to inspect at any time. In practice, many employers keep their payroll records for six years beyond the current year, to correspond with their accounting procedures.
19. Employers must also keep records of all expenses paid to employees and all benefits-in-kind provided to employees during the year. These are also reported, as required, after the end of the tax year. See **Error! Reference source not found.** on page **Error! Bookmark not defined.**
20. Records are subject to inspection by HMRC and penalties may be imposed for late or incorrect payments or returns. If HMRC finds that tax and/or NICs have been underpaid, the employer may be required to settle the unpaid amounts, plus a penalty, plus interest at 6½% (since 6 September 2005). In reverse, HMRC pays interest at 2¼% on overpaid tax and/or NICs.

Gross to net example

21. Income tax is paid by employees. NICs, on the other hand, are paid by employers and, in most cases, by their employees. The following simplified example illustrates the basic concepts of calculating income tax and NICs on an employee's gross pay, in order to arrive at the net pay:

Basic Payroll - PAYE Tax and NICs

Example

An employee has gross earnings of £197 in a week. What is the net pay if

- (1) the tax-free pay and the NICs-free pay is £97,
- (2) the tax rate is 22%,
- (3) the employee NICs rate is 11%, and
- (4) the employer NICs rate is 12.8%?

Gross Pay		£197.00
Tax-free pay	£ 97.00	
Taxable Pay	£100.00	
Income Tax		-£ 22.00
NICs-free pay	£ 97.00	
NICable Pay	£100.00	
Employee NICs		<u>-£ 11.00</u>
Net Pay		<u>£164.00</u>
Employer NICs		£ 12.80

Explanation

Each employee's tax code indicates the amount that may be earned free of tax during the tax year. Only earnings above that amount attract an income tax liability. In the simplified example above, the tax-free pay in one week is £97. Tax is due, therefore, on the remaining £100 of earnings.

For the sake of the example, the tax rate is assumed to be 22%. The tax due, therefore, is 22% of £100, i.e. £22.00.

The first £97 of earnings each week is also free of employee NICs. NICs are due on the remaining £100 of earnings.

The standard rate at which employees pay NICs is 11%. The NICs due are 11% of £100, i.e. £11.00.

Net Pay is £164.00, i.e. £197, minus £22 tax, minus £11.00 NICs.

The employer NICs are 12.8% of £100, i.e. £12.80.

Documentation and support

22. New employers, upon registration, are supplied with a Starter Pack, containing most of the forms and booklets required to administer PAYE and NICs. Thereafter, those forms and booklets that change annually are supplied automatically in the Employer Pack and CD-ROM each February and in the Budget Pack and CD-ROM, usually each April.
23. Most of HMRC's forms and booklets are available from the Employer Orderline and are listed on the *E3 Order Form*, a copy of which is included in the annual Employer Pack. Orders may be placed
 - by post, using the *E3 Order Form*
 - on the Internet, at <http://www.hmrc.gov.uk/employers/emp-form.htm>
 - by fax, using the *E4 Fax Order Form*

- by telephone, to the Employer Orderline, on 08457 646646, calls are charged at local rates. The lines are open between 8 a.m. and 10 p.m., Monday to Friday, and from 10 a.m. to 1 p.m. on Saturday.
24. A CD-ROM containing all of the leaflets and forms for the current year is supplied with the annual Employer Pack and the later Budget Pack.
25. The main booklets required to administer PAYE and NICS during the 2006/07 tax year are:

E10(2006)	<i>Finishing the tax year up to 5 April 2006</i>
E11(2006)	<i>Starting the tax year from 6 April 2006</i>
E12(2006)	<i>PAYE and NICs rates and limits for 2006-2007 (effective 6 April 2006)</i>
E12(2006)(2)	<i>PAYE and NICs rates and limits for 2006-2007 (effective first payday on or after 18 May 2006)</i>
E13(2006)	<i>Day-to-day payroll (effective 6 April 2006)</i>
CWG2(2006)	<i>Employer Further Guide to PAYE and NICs</i>
Tables A(1993)	<i>Pay Adjustment Tables</i>
Tables SR + B to D (May 2005)	<i>Taxable Pay Tables (up to last payday before 18 May 2006)</i>
Calculator Tables (May 2005)	<i>Taxable Pay Tables – Calculator Method (up to last payday before 18 May 2006)</i>
Tables SR + B to D (May 2006)	<i>Taxable Pay Tables (from first payday on or after 18 May 2006)</i>
Calculator Tables (May 2006)	<i>Taxable Pay Tables – Calculator Method (from first payday on or after 18 May 2006)</i>
CA38(2006)	<i>Not contracted-out NICs Tables A and J</i>
CA41(2006)	<i>Not contracted-out NICs Tables B and C</i>

26. Other booklets that may be essential for payroll administration for some employers but are not the subject of these course notes:

E14(2006)	<i>What to do if your employee is sick</i>
E14(2006) Supplement	<i>What to do if your employee is sick – Special Cases</i>
E15(2006)	<i>Pay and time off work for parents</i>
E15(2006) Supplement	<i>Pay and time off work for parents – Special Cases</i>
E16(2006)	<i>Pay and time off work for adoptive parents</i>
E16(2006) Supplement	<i>Pay and time off work for adoptive parents – Special Cases</i>
E17(2006)	<i>Employer Guide to the Collection of Student Loans</i>
CA39(2006)	<i>Not contracted-out NICs Tables D, E and L</i>
CA41(2006)	<i>Not contracted-out NICs Tables F, G and S</i>
490	<i>Employee travel, a tax and NICs guide for employers</i>
CA44(2006)	<i>National Insurance for Company Directors</i>

27. The main forms required to administer PAYE and NICs during the 2006/07 tax year, and those that will be considered in detail in this course, are:

P45	<i>Details of employee leaving work</i>
P46	<i>PAYE Employer notice to Tax Office</i>
P11(2006-07)	<i>Deductions Working Sheet</i>
P6*	<i>Notification of Tax Code</i>
P38(S)(2006)	<i>Students working during holidays</i>
P30B	<i>Monthly payslip</i>
P32(2006-07)	<i>Employer Payment Record</i>

* A computer-generated P6 coding notice is known as a P6(T). The “T” has no significance for employers and “P6” is used throughout these course notes.

Basic Payroll - PAYE Tax and NICs

28. Care must be taken to ensure that only the current versions of forms and booklets are used. Those that change show the year in brackets, e.g. P38(S)(2006).
29. HMRC guides and booklets are, as each one states, **not** guaranteed to provide a true interpretation of the law. Further advice should be obtained, as appropriate, from Accountants, Support Desks of payroll software suppliers or payroll bureaux, payroll handbooks, or the employer's tax office.
30. Questions may also be posed anonymously to the Employer Helpline on all aspects of PAYE and NICs. Calls are charged at local rates.
 - For established employers, the "one for three" telephone number is 08457 143143. The Helpline operates from 8:30 a.m. to 8:00 p.m. Monday to Friday, from 8:00 a.m. and 5:00 p.m. at weekends and on most bank holidays.
 - For newer employers (less than 3 years), the telephone number is 08456 070143. The Helpline operates from 8:00 a.m. to 8:00 p.m. Sunday to Friday, and from 8:00 a.m. and 5:00 p.m. Saturday and on most bank holidays.

Glossary of terms

Accounts Office	The office of the Collector of Taxes to whom payments of tax and NICs are made, either in Shipley or Cumbernauld
Basic Rate	The 22% tax rate
Contracted-out	Employee is a member of a pension scheme that is contracted-out of the S2P, and both employee and employer pay lower NICs. (See "S2P" and "Not contracted-out")
Emergency code	Tax code that gives the personal tax allowance, i.e. 503L for 2006/07
ET	Earnings Threshold, the level of an employee's earnings at which both employers and employees start to pay NICs
Gross Pay	Earnings on which NICs are due, at times distinct from "Taxable Pay"
Higher Rate	The 40% tax rate
HMRC	Her Majesty's Revenue & Customs, formerly the Inland Revenue
LEL	Lower Earnings Limit, the level of an employee's earnings from which lower NICs rates are paid when employees are contracted-out
NICO	HMRC National Insurance Contributions Office that deals with NICs matters
NICs Tables	Contribution Tables CA38, CA39, CA41, CA43
NICs	National Insurance contributions
NINO	National Insurance Number
Not Contracted-out	i.e. not contracted out of the S2P, and both employee and employer pay standard NICs. (See "S2P" and "Contracted-out")
PAYE	Pay As You Earn
PAYE Reference	The employer's PAYE scheme reference, as allocated by HMRC
Personal Allowance	That part of income on which no income tax is due
Reduced Rate NICs	Paid by some married women and widows
S2P	The State Second Pension scheme, an additional pension based on each employee's earnings over the LEL
SAP	Statutory Adoption Pay
SLD	Student Loan Deductions
SMP	Statutory Maternity Pay
SPP	Statutory Paternity Pay
SSP	Statutory Sick Pay
Starting Rate	The 10% tax rate
Tax code	An alphanumeric code that serves to identify the amount of an employee's earnings on which no tax is due
Tax month	6th of one month to the 5th of the next
Tax office	HMRC office that deals with an employer's PAYE and NICs matters
Tax Tables	Pay Adjustment Tables A, and Taxable Pay Tables SR + B to D
Tax week	A week starting on whatever day is the 6 April, or on the same day of the week in any subsequent week during the tax year
Tax year	6 April in one year to 5 April in the next
Taxable Pay	Earnings on which income tax is due under PAYE, at times distinct from "Gross Pay"
UEL	Upper Earnings Limit, the level of an employee's earnings (1) from which employees pay the lower NICs rate, and (2) up to which lower NICs rates are paid when employees are contracted-out