CHAPTER 21

INTRODUCTION TO PAYE

21.1 Introduction

The Pay As You Earn (or PAYE) system is a method by which tax is deducted from **employment income** at source. **PAYE** is not a tax in itself – it is simply a system under which tax on employment income and National Insurance is taken from salaries at the point of payment and handed over to HMRC. ITEPA 2003, s. 684 SI 2003/2682

PAYE schemes are operated by employers. HMRC use employers as unpaid tax collectors on their behalf. If employers fail to operate PAYE correctly there are penalties for these failures.

The PAYE system aims to recover tax and National Insurance wherever "PAYE income" is paid to an employee. National Insurance Contributions are paid by both employers and employees and we shall take a detailed look at NIC in a separate chapter.

The PAYE regulations also contain detailed provisions with regard to the collection and recovery of tax and NIC, the retention and production of records, interest and penalties for compliance failures and PAYE appeal procedures.

PAYE must be applied at the "time of payment". The date at which PAYE income is "paid" is defined in Section 686 as the earlier of: ITEPA 2003, s. 684 (2)

(i) the time when payment is made; and

(ii) the time when the person becomes entitled to the payment. ITEPA 2003, s. 686

There are special rules for directors as discussed in Chapter 15.

Employers pay the PAYE tax and NIC to HMRC on a monthly basis on the 19th of each month. The **due date** for payment is **14 days after** the **end of the tax month** of payment, and each tax month ends on the **5th** of the month.

There is one exception to this. If the total tax and National Insurance Contributions payable by the employer are less than £1,500 per month on average, the employer has the option to make payments under PAYE on a quarterly basis. For this purpose, the four tax quarters end on 5 July, 5 October, 5 January and 5 April, so PAYE payments are due 14 days after each of those quarter ends. SI2003/2682 Reg 70

21.2 PAYE income

ITEPA 2003 defines "PAYE income" in s.683. It consists of:

ITEPA 2003, s.683

(i) PAYE employment income (see below).

(ii) PAYE pension income (e.g. payments by employers to former employees under pension schemes); and

(iii) PAYE social security income (e.g. Statutory Sick Pay and Statutory Maternity Pay paid by employers to relevant employees).

We are mostly concerned with PAYE employment income which consists of:

(i) any taxable earnings from an employment in the year; and

(ii) any taxable specific income from an employment in the year.

This definition therefore covers most cash payments made by employers to employees including salaries, bonuses, round sum allowances and the taxable element of termination payments taxed under s.401 ITEPA 2003.

There are some cash payments made by an employer to an employee that will not be subject to PAYE. For example, the payment of mileage payments in excess of the authorised amounts is not subject to PAYE – the excess is simply reported on form P11D. The main example is the payment or reimbursement of the genuine business expenses which we looked at in Chapter 20. Genuine business expenses are simply reported by the employer on Form P11D, unless a dispensation is in place in which case they do not need to be reported.

If the amount of a private expense is reimbursed to the employee, the amount reimbursed will be subject to PAYE. However, if the amount is paid directly to the supplier, then PAYE will not be due. If there is a profit element in respect of the reimbursement of a business expense, for example where an employee takes a journey in the performance of his duties, but is reimbursed more than the actual cost, the excess is treated as a private expense.

PAYE is not just restricted to payments in cash. If an employer makes a non-cash payment to an employee, i.e. some form of payment in kind, and that payment in kind can be **surrendered** for cash, the amount of cash that the payment can be surrendered for is subject to PAYE.

A payment in the form of a premium bond for example, will constitute earnings for PAYE purposes because the employee can take the premium bond to the Post Office and has a legal right to be able to exchange the premium bond in return for cash.

Note here the specific use of the word "**surrender**". This is very different to the word "**sale**". For example, if an employee were given a yacht as a bonus by his employer, this would not constitute earnings for PAYE purposes as he could not take the yacht back to the shop and demand cash from the shop owner. This is not an asset that can be "surrendered" for cash in the same way as a premium bond.

Payments to employees in the form of **"readily convertible assets"** are also subject to PAYE. A "readily convertible asset" is an asset which is tradeable on a recognised **Stock or Commodities Exchange**. These assets will include quoted shares – i.e. shares listed on a recognised Stock Exchange and gold bullion amongst other things.

ITEPA 2003, s.696
ITEPA 2003, s.702

For example, consider an employee who works for Marks & Spencer plc, and as part of his remuneration he is given shares in Marks & Spencer plc. As these shares are listed on the UK Stock Exchange, they are readily convertible assets and tax at source under PAYE would have to be deducted from the payment.

A readily convertible asset also includes any asset for which **trading arrangements** exist. A trading arrangement basically means that the employer has arranged for the employee to be able to sell the asset which has been awarded to him – i,e. the employer arranges for the employee to receive cash from a third party in return for the asset.

For example, assume that as part of an employee's remuneration, his employer gives him a brand new Ferrari. There is no recognised Commodities Exchange for Ferraris, but if, as part of the deal, the employer has arranged with a third party for the employee to be able to sell that Ferrari and receive cash in return, the asset is a readily convertible asset and PAYE will have to be applied to the payment.

When PAYE needs to be accounted for in respect of a readily convertible asset, the tax deducted may reduce an employee's cash pay to nil. Any amount of PAYE which cannot be deducted from cash pay must be recovered from the employee **within 90 days** of receipt of the non-cash payment. If any amount is not recovered from the employee, it must be recorded as a benefit for the employee at the end of the tax year.

An employee may be provided with vouchers as part of their remuneration package. Vouchers which can be exchanged for cash count as earnings for PAYE purposes and the amount of cash for which they can be exchanged will be subject to PAYE. Vouchers which can only be exchanged for goods and services are not earnings for PAYE purposes, unless they can be exchanged for a readily convertible asset.

Normal benefits such as the use of a **company car** or a **taxable cheap loan** or **living accommodation**, are not generally subject to deduction of tax at source under PAYE. These benefits are usually entered on **form P11D** and tax is paid on these benefits at the end of the year under Self Assessment.

However, as we shall see later, in order to prevent there from being a large underpayment of tax on benefits at the end of the year, HMRC usually tax benefits via the employee's tax code. We shall deal with tax codes later on in this chapter.

21.3 How the PAYE system works

Once the employer has arrived at the employee's PAYE income for a particular earnings period – the most common earnings period being that of one month – this income is entered on to a PAYE deductions sheet. The employer then calculates tax on the income using the employee's **tax code**.

The purpose of a tax code is for HMRC to tell the employer what allowances etc., are due to the employee. For example, people with adjusted net income not exceeding £100,000, will be entitled to the basic personal allowance in 2010/11 so they can earn a certain amount of tax-free pay every month. This tax-free pay is deducted from the PAYE income and the excess is charged to tax.

The employer calculates the precise amount of tax due using tax tables. These tables are provided by HMRC and there are separate tables for tax and National Insurance Contributions.

The employer looks at the monthly gross pay, then looks at the employee's tax code and where these two points meet on the tax tables, that is the income tax to be deducted for that particular month. What the tables effectively do is to take **gross pay, deduct some personal allowances where available**, and charge the **excess** at **20%** and, if relevant, at **40% and 50%.**

Once the employer has arrived at the tax and the National Insurance to be deducted, this is withheld from gross pay and the net amount is paid to the employee.

It is the employer's responsibility to keep records of all PAYE income paid to employees and of the tax and National Insurance deducted from that income. These pay and tax details will be recorded on various returns sent to HMRC at the end of the year. PAYE returns will be dealt with in the next chapter.

21.4 Tax Codes

The **tax code** is issued by HMRC to **employers** on form P9(T) or form P6 if changes are made to the code in the tax year.

A detailed breakdown of how the Revenue has arrived at the **tax code** is given to the **employee** on a different form - **form P2**.

Note here that the employer only receives the "bottom line" figure – i.e. the employer does not receive the detailed breakdown of the code as this is confidential information given to the employee only.

The purpose of the tax code is to tell the employer **how many allowances or reliefs** the employee is entitled to. These allowances will include personal allowances, age allowances and any other reliefs such as qualifying interest or EIS relief etc.

The tax code will also take account of any benefits to which the employee is entitled. The tax code takes the employee's allowances for the year, deducts any benefits the employee has for the year and the difference is the net allowances due to the employee.

Allowances for year	X
Benefits	(X)
Net allowances due	X

These net allowances are the employee's tax-free pay. By restricting an employee's allowances by the amount of his benefits, what HMRC are doing is effectively taxing benefits on a monthly basis as they go along. HMRC do this to prevent the employee having a large tax bill at the end of the year.

Illustration 1

Mr Jones is entitled to a personal allowance in 2010/11 of £6,475. In the tax year he also receives some benefits from his employer. He has a company car with a benefit of £1,690. He is also provided with private fuel for that car, giving rise to a benefit of £2,700.

Tax code:	£	£
Personal allowance		6,475
Benefits:		
Car benefit	1,690	
Fuel benefit	2,700	
		(4,390)
Net allowances		**£2,085**
Tax Code		**208L**

HMRC will convert this tax-free pay of £2,085 into a tax code. To do this they knock off the end figure – i.e. remove the 5 – and replace that number with the letter L. So the tax code here is 208L. The suffix L simply means that Mr Jones is entitled to the normal Personal allowance.

In practice you may be asked by your client to check the detailed breakdown of the code to make sure that the allowances and the benefits within the tax code are correct.

What you are doing is simply checking that HMRC are deducting more or less the correct amount of tax each month under PAYE. Any extra tax owed to HMRC, or any repayments due to the taxpayer, will be dealt with once the Self Assessment return has been submitted.

Notices of Coding can take account of allowances other than the basic personal allowance. For example, they can take account of tax reducers such as subscriptions to EIS companies and any married couples relief due to older taxpayers. The codes can also take account of Gift Aid donations and any contributions to pension schemes which attract tax relief. Tax codes are also very commonly used to deal with tax under or over payments from previous years.

The tax code can also be used to tax small amounts of other income likely to arise in the tax year, such as rental or investment income. However, a taxpayer can object to this income being encoded.

21.5 Underpayments of tax

PAYE is not an exact science, so the amount of tax deducted at source under PAYE will not always be exactly the same as the tax liability for the year. Most taxpayers in the UK will either have small under or over payments at the year end.

If the tax due for the year is less than £2,000, HMRC do not require this tax to be paid under Self Assessment on 31 January. Instead they are happy to collect this tax in a later tax year under PAYE. For example, if the underpayment occurs in 2008/09, HMRC will usually adjust the tax code in 2010/11.

The idea is that the employee will pay slightly more tax in the later year to cancel out the tax underpayment from the earlier year.

Illustration 2

Mr Wood is a basic rate tax payer, employed on a salary of £20,000 per annum and has a medical insurance benefit of £500. In 2008/09 Mr Wood had a tax underpayment of £150.

Mr Wood's tax code for the tax year 2010/11 is calculated as shown:

	£
Personal allowance	6,475
Benefits	(500)
Tax underpaid 2008/09	
£150 x 100/20	(750)
Net allowances	**£5,225**
Tax Code	**522L**

This calculation requires some explanations. We start with Mr Wood's allowances. He has a normal Personal allowance of £6,475.

Mr Wood's benefits for the year are £500, so these are deducted. In 2008/09 Mr Wood had a small underpayment that we need to deal with via his tax code. What we need to do here is to restrict Mr Wood's allowances by such an amount so as to create an extra tax liability of £150 in 2010/11.

As Mr Wood is a basic rate taxpayer, we do this by multiplying by 100 over 20 giving £750. We are effectively pretending that in 2010/11 Mr Wood has extra income of £750. When multiplied by the basic rate of 20%, this will create an extra tax liability of £150. This is the tax that he owes for the previous year.

The net allowances due for the year are the total allowances less the benefits and underpayment of tax, giving £5,225. We then knock off the final 5 and replace that with the letter L for normal personal allowances to give Mr Wood a tax code for the year of 522L.

21.6 K Codes

A "K" code is a negative code and will arise where benefits **exceed allowances for the year**. So whereas in the case of a normal code an employee has an amount of tax free pay each month, where an employee has a **"K" code this will actually increase the taxable pay**.

If an employee has a normal personal allowance and total benefits of £8,440 for the year his code will be as follows:

	£
Personal allowance	6,475
Benefits	(8,440)
Negative allowance	£(1,965)
Tax code	K195

A "K" code is so-called because the code is prefixed by the letter K. Here we take £1,965, we remove the final 5 to give us 196, then HMRC **deduct one** to give 195. HMRC put a "K" on the front so that the code becomes **K195.**

Of course, if the employee has adjusted net income in excess of £112,950 in 2010/11 he will not be entitled to a personal allowance. If he has no other reliefs available, his code will be as follows;

	£
Personal allowance	Nil
Benefits	(8,440)
Negative allowance	£(8,440)
Tax code	K843

This will be notified to the employer by HMRC on form P9(T). This tells the employer to increase the employee's PAYE income by a certain amount each month, so as to effectively tax the benefits at source. This prevents a large tax underpayment from arising at the end of the year.

When a **K code** is used, the **maximum amount of tax that can be deducted in any period cannot exceed 50% of gross pay**. For example, if an employee has gross cash pay of £3,000 in a month, the maximum amount of tax that can be deducted under PAYE is £1,500. This is to prevent hardship - i.e. to prevent an employee's cash pay from being totally wiped out in tax.

The sole purpose of the code is to determine how much tax an employee pays each year under PAYE. If you think back to your income tax computation, you always tax gross earnings and then deduct tax already paid under PAYE at the bottom to give you a figure of tax due or tax repayable. As far as is possible, HMRC will try to make the tax deducted under PAYE more or less equal to the employee's tax liability for the year by using the tax code system. However, they understand that PAYE codes cannot be totally accurate, so small under or over payments are inevitable.

If on receiving his form P2, an employee thinks that his tax code is incorrect, the employee can make an appeal to HMRC. The appeal can be made in writing or, the employee can telephone the Tax Office and ask them to change the tax code.

Example 1

Which of the following are PAYE income?

a) Performance related bonus
b) Statutory sick pay
c) Company car
d) Non taxable business expenses
e) Bonus paid in silver bullion
f) Compensation for loss of office in excess of £30,000.

Example 2

Albert was 76 on 1 February 2011. He is married to Elsie who is 69.

Albert has a part time job paying £18,000 per annum

He has no benefits and no other income.

Calculate what his tax code for 2010/11 will be.

Answer 1

	PAYE income?
a) Performance related bonus	✓
b) Statutory sick pay	✓
c) Company car	X
d) Non-taxable business expenses	X
e) Bonus in silver bullion	✓
f) Compensation for loss of office	✓

Answer 2

	£
Personal age allowance	9,640
Married couples relief	
£6,965 x 10% = £696	
Given as	
$696 \times \frac{100}{20}$	3,480
Total allowances	**13,120**
Tax Code	**1,312Y**

Albert is 76 and so is entitled to the Personal Age allowance. He is married so he is also entitled to Married Couples relief as he was born before 6 April 1935. Albert has a salary of £18,000 and no other income. This means that as his income is less than £22,900, these allowances are given in full with no restriction.

Albert's Married Couples relief will be £6,965 at 10%. Married Couples relief is given as a tax reducer so we need to factor this in to Albert's tax code. We therefore need to increase Albert's allowances by such an amount that it saves Albert tax of £696. As Albert is a basic rate taxpayer we do this by multiplying by 100 over 20.

This has the effect of giving Albert additional allowances of £3,480. The idea is that by increasing Albert's allowances by £3,480, we save him tax at 20% giving rise to a tax saving of £696.

Adding these together gives Albert total allowances of £13,120. We remove the last digit to give us a tax code of 1,312 and this time we add the suffix which denotes that Albert is entitled to the higher allowances available to persons over age 75. So Albert's tax code will be 1,312Y.

(Note: the various coding suffixes ("L", "Y" etc) are not important for examination purposes).