

Practical TAX Newsletter

Pay day by pay day tax relief models

David Kirk explains what these are.

What on earth?

If you come across an HMRC statement with the heading *Pay Day by Pay Day Tax Relief Models* you might feel justified in throwing up a sigh and asking 'What on earth are they barking at now?' In fact the impact of this statement, issued in July 2011, and a further one with the even less exciting title of *Pay Day by Pay Day Tax Relief Models and Dispensations* (August 2012), is likely to be fairly narrow. There is a clue to this in the next paragraph, which says: 'Who should read this statement? All umbrella companies, employment businesses, labour providers and employers engaging and paying temporary workers.' This sector is known to be under the HMRC spotlight for its addiction to sailing close to the wind, and the practice complained of is unlikely to be replicated much elsewhere.

The model

What the statements are aimed at are what might be called 'top down' expenses models, which are common in the temporary labour market and particularly among umbrella companies – i.e. companies whose basic business is to hold employment contracts and pay people. Economically speaking, the way that the model works is something like this:

1. Mr Builder signs up with Umbrella Ltd to handle his pay for a fee of £25 a payslip; this £25 is where Umbrella expects to make its profit. These models are common in the construction industry where people move from one job to another frequently.
2. Builder works for Construction Ltd on a site, and Umbrella invoices Construction for his services – say £500 for the first week. This looks rather like an employment agency set-up, except that an employment agency will actually be seeking work for Builder to do and seeking other workers to work for Construction. An umbrella company does not do any of that but purely processes Builder's pay when it comes in, which is why it only needs £25 a week to make a profit.
3. When the money comes in, Umbrella does a quick calculation. It takes off its fee of £25, and then asks how much it can pay to Builder tax-free by way of expenses. Builder has put in a mileage claim for £100, so we have the answer to that one; this leaves a pot of £375 to go through the normal PAYE process. Take off employer's NI which its bespoke computer program calculates at £28, and this leaves: £347 as the basic pay on which to calculate the employee's PAYE and NI. Check that this is

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enough to comply with the national minimum wage – yes, tick that box; print off the payslip, send Builder the money (including expenses of course) and there we are: job done. The key point is that the basic pay is a balancing figure, not something that is agreed in advance between the parties.

Simply stirring it in the pot and pulling it out again is problematic.

Does this actually work?

This is what these two HMRC statements are all about, and the reason they are so extensive is that the answer is; ‘it depends’. ‘It depends’ because umbrella companies are frequently run by accountants who know their law in this area, and what HMRC are trying to do is to point out one or two practices that do not work.

The most important thing to understand in order to get this right is that it is necessary to earmark expense payments as such: there can be no fudge that leaves an amount of money as an expense payment for one purpose and salary for another. NI is raised on ‘earnings’, which ‘includes any remuneration or profit derived from an employment’ (Social Security Contributions and Benefits Act 1992, s. 3).

Has the £100 mileage payment here been ‘earned’? It might be quite hard to argue that it has not, as a matter of economic reality. It could possibly be excluded from ‘earnings’ under Social Security (Contributions) Regulations, Sch 3 part VIII para 7A (SI 2001/1004), but for this to be so it would also have to pass ITEPA 2003, s 230 (referred to in regulation 22A) and be a ‘mileage allowance payment’ – that is to say an ‘amount ... paid to an employee for expenses related to an employee’s use of ... a vehicle for business travel’ (see s. 229). Note the words ‘amount for expenses’ here: it must be a separate amount and labelled as such. Simply stirring it in the pot and pulling it out again is problematic: it might work, but one would have to be very careful about how one documented as well as calculated the sum, as well as being

aware that one is on the cutting edge of the law and likely to attract a Revenue challenge.

For other travelling expenses the position is a bit clearer, and can be found in Sch. 3 part VIII para 3 of the regulations. This disregards ‘a payment of, or a contribution towards, travelling expenses which the holder of an office or employment is obliged to incur and pay as the holder of that office or employment’, and goes on to define travelling expenses broadly in line with ITEPA 2003. Once again, to qualify it must be identified as such.

What is HMRC warning us against?

Where the employer **separately and distinctly** (HMRC’s emphasis) pays or reimburses travelling expenses then these expenses are outside NI. HMRC are understood to mean by this not that there has to be a separate payment, but that the amount must be separately identified and cannot be calculated in a top-down manner as in the example above – or, at the very least, the employer’s documentation must prescribe a ‘bottom-up’ calculation, where the basic salary is not a balancing figure.

A dispensation fulfils a narrow legal function.

PAYE

For PAYE, the strict legal position is that without a dispensation in place the expense payments are subject to PAYE; an employee can then make a claim on form P87 or his self-assessment tax return to have the business expenses offset against his income from employment. In practice HMRC frequently do not apply this rigorously, provided that all expenses are shown on the P11D so that they can see that the correct amount of tax is actually paid. This presumably suits them as well as both employers and employees, otherwise they would have large numbers of P87’s to process as well as having to issue endless coding

notices to take account of changing levels of expenses. This does however leave employers without a dispensation exposed to claims for PAYE if HMRC decide to apply the law strictly. This is because expense payments are ‘treated as earnings’ under ITEPA 2003, s 72.

Dispensation

An employer with a dispensation is not at that particular risk, but it remains the case that the payment must be covered by the dispensation for there to be no PAYE on it. A dispensation can only cover payments made under the ‘listed provisions’ in ITEPA, 2003, s 216(4) which in the case of expenses payments means payments ‘in respect of expenses’ (s. 70(1)(a)). Once again, we see the necessity of labelling the payment. Also in this context, HMRC are particularly keen to point out that the grant of a dispensation does not mean that they are approving the employer’s entire expense payment regime: a dispensation fulfils a narrow legal function, and is something that if certain conditions are fulfilled they have no discretion to refuse.

NMW

There is one other important point covered by these statements. HMRC take the view that any system that reduces the taxable income below the national minimum wage (NMW) is very unlikely to be compliant. This also arises out of the necessity for labelling. The calculation of payments that qualify for the NMW specifically excludes payments of allowances and requires expense payments to be deducted from the calculation.

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David Kirk

David Kirk MA FCA CTA is a specialist consultant in payroll taxes. He can be contacted at dk@david-kirk.info or on 07778 361552. His book Employment Status – the Tax Rules is published by Claritax Books.