Making Tax Digital for Individuals: Dynamic Coding (PAYE Refresh)

Employment Tax

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PAYE is changing, HMRC is starting to use RTI data from employers in real time when recalculating employees' tax codes. The RTI feed will be used to estimate earnings when a tax code review is triggered, for example when a new benefit-in-kind is notified. Where HMRC calculate that the new tax code will under-collect tax for the remainder of the year an in-year restriction will be included in the tax code, aimed at collecting that estimated underpayment in year.

As mentioned in recent Employer Bulletins HMRC will, from July, begin to use real time information (RTI) from employers when making adjustments to PAYE tax codes. They will also use other third party information, for example, from other government departments, banks and building societies. The aim is to improve the accuracy of tax codes in-year and reduce the number of end of year under- and over-payment reconciliations (P800s): around 8 million reconciliations are required each year. A reduction in year-end reconciliations was one of the promised benefits of introducing RTI, so after 4 years it is perhaps time for HMRC to start to deliver, even if it does mean that employers will receive tax code adjustments more frequently in future.

A key part of dynamic coding are the 'trigger points' for starting a review of an employee's (or pensioner's) tax code. The receipt of RTI data from employers will not be a trigger point, unless the employer's Full Payment Submission (FPS) includes a start date for a new employment. Trigger points are effectively notifications of change in circumstances, such as new employment, new benefit-in-kind, increase in salary, etc.

When a coding review is triggered, HMRC will use the latest RTI data available to estimate earnings (or pension income) for the current tax year (unless the individual has provided HMRC will an estimate of earnings that's not less than the year-to-date RTI figure). An assumption will be made that an employee will continue to receive the same level of pay for the rest of the tax year as they have to date.

For example, a monthly paid employee with a start date of 1 September 2017 and pay to date on an FPS dated 20 November 2017 of £6,000, will be assumed to earn £14,307 by 5 April 2018 (£6,000 / 91 days x 217 days).

This works fine if earnings accrue evenly throughout the year but if pay varies, for example, if it includes commission, or a bonus has been received early in the tax year, or will be received late in the year, then HMRC's estimate is likely to be inaccurate and it will be important for the individual to provide their own estimate of earnings.

If, for example, HMRC are notified of a new company car, the tax code review is triggered and the code will be amended to include the benefit-in-kind that will arise in the tax year. Assuming the tax code number goes down the new code will be operated on a Week 1/Month 1 basis for the remainder of the tax year (or until another tax code replaces it).

Traditionally, a reduction in the tax code and its operation on a Month 1 basis will have resulted in an under-collection of tax at year end (a 'potential underpayment' (PUP)). In the past this would have been carried forward to the following tax year and coded out as an estimated underpayment (and a final reconciliation would be required after the end of the tax year).

With dynamic coding, HMRC is instigating a new process of collecting (or repaying) the tax through the current year's tax code rather than in the next one. The aim is to collect the correct amount of tax during the year through PAYE and, thus, reduce the number of annual P800 notifications. To achieve this HMRC will estimate the amount that would have been owed at the tax year end and include this as a restriction in the current year's tax code.

For example, an employee is provided with a company car on 31 October 2017 which gives rise to a benefit-in-kind for 2017-18 of £5,000. The employee promptly notifies HMRC off the new benefit and this triggers a tax code review. HMRC use the RTI data to estimate pay for the tax year as £25,000 (ie the employee will be a basic rate taxpayer) and calculate that revising the tax code for the car benefit and operating the revised code for the remainder of the tax year on a Month 1 basis will result in a PUP (renamed 'In-Year Adjustment' (IYA)) of £583.40. Rather than waiting for the tax year to end, dynamic coding will include an 'in-year restriction' (IYR) in the current year's tax code to collect the PUP.

The calculation is £583.40 x 100/20 = £2917 x 365/157 (31 October to 5 April) = £6,781 and the resulting tax code is:

Personal Allowance £11,500
Less: Car benefit £5,000
Less: IYR £6,781
Net allowances £-281 = Code K27

The 50% regulatory limit continues to apply, where appropriate, and HMRC cannot more than double an individual's liability when coding out an underpayment either (ie if the tax due on earnings for the year, excluding the underpayment, is estimated to be £1,000 then HMRC can only include in the tax code up to £1,000 in underpaid tax).

The key message is employee engagement – employees will need to tell HMRC about changes in circumstances, for example via their Personal Tax Account. Otherwise if employees (or their agents) do not tell HMRC things have changed then HMRC will assume they have not, and their systems will make year-on-year assumptions that are incorrect, leading to incorrect tax codes and continuing under- or over-payments!

Further explanation on how HMRC will be updating tax codes was given in the HMRC Talking Points meeting on 7 July 2017, a recording of which can be viewed at here (if you have not already done so, you will be required to register on the Citrix platform in order to view this and other HMRC recordings).