

Quick guide to PAYE

Introduction

The Pay As You Earn (PAYE) scheme was introduced in 1943 to collect tax from salaries and wages at source.

The scheme is operated by the employer who must calculate the amount of tax on each payslip and pay it to HMRC.

An employer must register for PAYE with HMRC. The employer is given a unique reference number that must be quoted by the employer and employees in any correspondence with HMRC.

If the scheme is operated properly, PAYE will ensure that the correct amount of tax is collected. The employee will often not need to complete a tax return or have any direct dealings with HMRC at all.

PAYE must be operated for all employees. It is not possible for an employer and employee to agree not to operate PAYE.

Employees includes directors of companies. All their remuneration must be taxed through the PAYE system. However sole traders and partners in a partnership are not taxed through a PAYE payroll.

For PAYE purposes, office holders are also regarded as employees. So PAYE must be operated for councillors, vicars, policemen, soldiers and other office holders.

PAYE calendar

For historic reasons explained in another article, the tax year runs from 6 April in one year to 5 April in the next.

The year is divided into tax months which run from 6th of the calendar month to 5th in the next month. So 6 April to 5 May is month 1; 6 May to 5 June is month 2 and so on. These tax months are used for monthly paid staff and for the payment of PAYE to HMRC.

The year is also divided into tax weeks for weekly paid staff. Week 1 runs from 6 April to 12 April. Week 2 from 13 April to 19 April and so on. Week 52 ends on 4 April (or 3 April in a leap year). If a payslip is paid on that day, a special week 53 procedure is used.

Tax code

The heart of the PAYE system is the tax code.

This usually comprises a number followed by a letter, such as 747L.

The number represents one tenth of the amount an employee may earn in the tax year without paying tax. In practice, £9 is usually added, so 747L means that £7,479 may be earned each year tax free.

The figure represents the personal allowance to which other allowances or reliefs may be added, and other sums (such as tax owed from a previous year, or benefit in kind provided by the employer) is subtracted.

Most payrolls are not run using a computer, though it is still possible to calculate the payroll manually using tax tables. Either way, part of that allowance is allowed for each payslip. In our example, the first £623 a month is tax free. So if the employee has gross pay of £2,623, only £2,000 is taxable. At a basic rate of 20% that means that £400 will be collected.

Tax codes are usually operated on a **cumulative basis**. This looks at how much:

- the employee has earned so far this year
- tax the employee should have paid so far this year
- how much tax the employee has paid so far this year.

When an employee is paid the same amount each week or each month, the tax is likely to be the same amount, subject perhaps to small differences for rounding.

However the cumulative basis can have a significant effect when an employee has not earned for part of the year or where the tax code has changed.

Suppose in our example, we are in month 6 but the employee had no earnings for months 1 and 2.

His gross pay for the year up to month 3 is £2,623. However he is entitled to £1,870 tax-free pay. This is known as the **pay adjustment**. This means that only £753 is taxable. So at 20%, he will pay only £150.60 tax.

Sometimes the tax due to date is less than the tax that has already been paid. In that case the employee gets a **tax rebate** that is automatically *added* to the pay. A tax rebate may not be paid if the employee is engaged in industrial action.

The PAYE system generally ensures that tax is collected at all rates, including any due at the higher rate of 40% and the additional rate of 50%.

And what of the letter on the end? That is simply to allow for mass adjustments of tax codes when a personal allowance is changed in the Budget. HMRC can simply say to payrollers increase all L codes by 100 points.

Sometimes tax codes are operated on a **month 1** or week 1 basis. That means that every payslip has the tax calculated as if it were month 1. This means that pay and tax for previous payslips in the tax year are ignored.

An employee may appeal to a tax tribunal about a code.

K codes

Sometimes an employee may have so many taxable benefits in kind or so much tax owed from a previous period, that the tax code is negative. For example, an employee may be entitled to a personal allowance of £7,475 but need to have £9,000 deducted as tax on benefits.

This is effected by a **K** code. In the example above, the employee has a negative net allowance of £1,525. This is represented by the code **K152**. The figure of 152 again represents the pay adjustment but this time it is *added* to gross pay to calculate the tax.

The amount of tax deducted under a **K** code usually cannot exceed half of an employee's gross pay.

Other tax codes

The tax code **BR** means that tax at the basic rate must be deducted from all earnings. There is no pay adjustment.

The tax code **0T** means that the pay adjustment is nil, so all the pay is taxed. This differs from **BR** in that it will collect any tax due at the higher or additional rate.

The tax code **NT** means that no tax is deducted. This is either because another arrangement has been made to collect the tax or because the employee is not liable to pay tax.

The tax code **D0** means that tax at the higher rate of 40% is deducted from all earnings. The code **D1** is the equivalent for the 50% additional rate.

Employee starts

When an employee starts, he or she should either hand in a P45 form or be asked to complete a P46 form.

A P45 form is provided by the previous employer or by the Department of Work and Pensions if the person has been receiving jobseeker's allowance or an equivalent benefit.

The P45 gives the tax code and amounts of how much the employee has earned and how much tax has been paid so far in the tax year. The employer in effect simply continues operating the tax code on the cumulative figures including previous earnings.

If an employee does not submit a P45, a form P46 is completed. On this the employee must state if this is their only or main job. If the answer is yes, the employer operates the **emergency tax**

code for the current tax year. If the answer is no, the employer uses code 0T (before 6 April 2011, code BR).

The employer completes the form P45 and sends it to HMRC.

There are special procedures for students working during the main vacations. There is a simplified procedure for domestic staff.

Employee leaves

When an employee leaves, he or she is given a P45. This states how much the employee has earned so far in the tax year, and how much tax has been paid.

This is notified to HMRC and is given to the employee to give to the next employer.

Monthly payment to HMRC

The employer must make a monthly or quarterly payment to HMRC of the tax collected in the month or quarter. A quarterly payment may be made if the employer reasonably believes that the monthly amount of PAYE payable will not exceed £1,500.

Monthly payments must be made for all PAYE deducted in the tax month (even for weekly paid staff). On-line payments to HMRC must be made by the 22nd of the month. That is 17 days after the end of the tax month. If the 22nd is not a working day, the payment must be made by the previous working day.

Quarterly payments must be made for all PAYE payments for the quarters ending on 5 July, 5 October, 5 January and 5 April. The on-line payment must be made within 17 days.

The payment to HMRC comprises all the tax deducted under PAYE, plus employees' and employer's national insurance contributions and student loan deductions for the period. From this may be subtracted any statutory maternity pay and other statutory payments for which a repayment claim may be made.

Year-end procedures

At the end of the year, payroll must prepare a P35 return listing all employees and giving payroll data about them.

For each employee a P14 form must also be prepared. The employee receives a copy of the P14 known as the P60. This is an annual tax certificate that is evidence of how much the employee has earned in that employment, and how much tax and national insurance has been paid.

A form P11D must be prepared giving details of all benefits in kind paid to directors and to employees who earn more than £8,500 a year. A form P9D may need to be completed for other employees who receive taxable benefits in kind.

There are due dates for submitting all these monthly, quarterly and annual returns. There are penalties for lateness or non-compliance.