EXPLANATORY MEMORANDUM TO

THE INCOME TAX (PAY AS YOU EARN) (AMENDMENT) (No.2) REGULATIONS 2011

2011 No. 1054

1. This explanatory memorandum has been prepared by Her Majesty's Revenue & Customs (HMRC) and is laid before the House of Commons by Command of Her Majesty.

1.1 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These regulations amend the Income Tax (Pay As You Earn) Regulations (S.I. 2003/2682)("the PAYE Regulations 2003") to the effect that:

- Payments made by an employer to an employee after their employment has ceased which are not included on the form P45 will be taxed using the zero T (0T) tax code on a non-cumulative basis.

- Payments made in connection with employment related securities made after the employee has left the employment will be taxed at the basic rate of tax.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 The Income Tax (Pay As You Earn) (Amendment) Regulations (SI 2011/729) laid before the House on 11th March 2011 and coming into force on 6th April 2011, made a number of amendments to the PAYE Regulations 2003 including a change to the tax code employers operate against payments made to employees after leaving employment. The tax code changed from the flat rate basic rate (BR) code to zero T (0T) operated on a non cumulative basis.

3.2 General concerns around the operation of the 0T tax code were received before the SI 2011/729 was laid. As a result HMRC reviewed its processes and made necessary amendments to its guidance. However, it was not until the receipt of a very late representation that the impact of the proposed tax code change on payments made in connection with employment related securities was set out clearly for the first time. As a result of the representations, consultation with technical experts was required before relevant amendments in these Regulations could be made.

3.3 An income tax charge can arise on payments made in connection with employment related securities. Share scheme administrators usually dispose of shares, the proceeds of which are used to meet that tax liability. The operation of the 0T tax code in these circumstances could result in more shares being realised than the eventual adjusted tax liability arising in respect of the share realisation. This could act as a large disincentive to invest in employment related share schemes both by employers and employees.

3.4 HMRC took immediate action to mitigate these effects and are amending regulation 37 of the PAYE Regulations 2003 to take effect immediately after the coming into force of SI 2011/729 so that payments made in connection with employment related securities continue to be taxed at basic rate from 6th April 2011. In order to bring this change into effect by 6th April 2011 it has not been possible in the circumstances to allow 21 days to elapse between the laying of the instrument and its coming into force. If these Regulations were not brought into force on 6th April 2011 it would mean the 0T code would apply for a short period in the tax year unfairly impacting a small number of taxpayers.

4. Legislative Context

4.1 The PAYE Regulations 2003 are made under section 684 of the Income Tax (Earnings and Pensions) Act 2003 which requires the Commissioners of Her Majesty's Revenue and Customs to make regulations with respect to the assessment, charge, collection and recovery of income tax of all PAYE income.

4.2 Regulation 37 of the PAYE Regulations 2003 applies when an employer makes a payment to an employee after their employment has ceased and that payment is not included on the form P45. In these circumstances, the employer must deduct tax at the basic rate. Regulation 8 of SI 2011/729 amends regulation 37 of the PAYE Regulations 2003 so that employers will be obliged to operate code 0T against any such payments.

4.3 The Income Tax (Pay As You Earn) (Amendment) (No.2) Regulations 2011 ("Amendment No.2 Regulations 2011") come into effect immediately after the coming into force of SI 2011/729. Regulation 3 of the Amendment No 2. Regulations 2011 substitutes for paragraph 2 to regulation 37 of the PAYE Regulations 2003 new paragraphs 2, 2A and 2B. Substituted paragraph 2 confirms that tax must be deducted from PAYE income paid after an employment has ceased using the tax code 0T on a non-cumulative basis and confirms that it does not apply to circumstances described in paragraph 2A. Guidance has already been provided by HMRC to employers prior to these amended regulations to confirm that the 0T code must be operated on a non-cumulative basis in the circumstances where it applies.

4.4 Paragraph 2A requires that a person making a payment in connection with securities, interests in securities or securities options to which Part 7 or Chapter 1 of Part 3 of the Income Tax (Earnings and Pensions) Act 2003 applies must deduct tax at the basic rate in force for the tax year in which the payment is made. Paragraph 2A will cover payments made in connection with employment related share schemes. All other payments of PAYE income paid after an employment has ceased fall within paragraph 2 and will be subject to tax deducted using the 0T tax code on a non-cumulative basis.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 These amendments are being made to make clear that the 0T tax code should be used on a non-cumulative basis against payments of PAYE income made after an employee has left employment and provide that payments arising from employment-related securities should be taxed at basic rate. This change is being made since it has been made clear to HMRC that the operation of 0T may present administrative difficulties for companies operating employee share schemes, in particular necessitating the sale of excessive numbers of shares to meet PAYE requirements for tax which may not ultimately be due over the year as a whole.

8. Consultation outcome

8.1 Formal consultation was not undertaken in respect of these amendments. HMRC received representations against one of the amendments provided for by SI 2011/729 and has taken urgent action to make a further amendment that will come into effect, and thereby replace the earlier amendment, on 6th April 2011. It was not possible for HMRC to undertake consultation in the very short time scale available.

8.2 If HMRC had not made this change by 6th April 2011 employees leaving employment and receiving payments in connection with employment related securities would have been adversely affected by the operation of the zero T (0T) tax code against those payments.

9. Guidance

9.1 We have provided guidance to employee share scheme administrators which confirms that they will be required to deduct tax at the basic rate on share scheme realisations arising as a result of an employee leaving employment.

9.2 HMRC’s existing employer guidance confirms that all other payments made to employees after leaving employment must be taxed using the 0T tax code operated on a non cumulative basis.

10. Impact

10.1 A Tax Impact Information Note covering this instrument will be published on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm.”

11. Regulating small business

11.1 The legislation applies to small business.

11.2 The first amendment provided for by this Instrument will clarify the basis on which the 0T tax code will operate against cash payments. The second amendment will enable employers who operate employment related share schemes to continue to operate the basic rate tax code against payments made out of those schemes to an employee who has left their employment.

11.3 The second amendment above will apply to small businesses but there will be no impact because it returns those small businesses who are in a position to offer their employees share incentives by means of employment related share schemes to the position they were in before the previous amendments were made.

12. Monitoring & review

12.1 We continue to monitor the operation and administration of PAYE and any adverse changes arising from these amendments will be assessed.

13. Contact

Lynn Carroll at HMRC Tel: 020 7147 2636 or email: lynn.carroll@hmrc.gsi.gov.uk can answer any queries regarding the instrument.