Unpaid employment taxes: shifting liability

Employment Tax



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We outline the main provisions under which HMRC can transfer the liability for unpaid employment taxes via a personal liability notice, transfer notices or deeming provision.

Key Points

What is the issue?

We explore the legal mechanisms through which HMRC can shift liability for unpaid employment taxes – specifically income tax and NICs – from employers to individuals or third parties. Employers are primarily responsible for deducting and remitting these taxes, but HMRC has powers to transfer liability in cases of fraud, neglect or non-compliance.

What does it mean to me?

HMRC can issue personal liability notices to company officers if unpaid NICs result from their fraud or neglect. Similarly, HMRC can shift income tax liability to employees if employers acted in good faith or if employees knew of deliberate under-deductions.

What can I take away?

The article also discusses notional payments – non-cash benefits treated as taxable income – and how employers must still account for PAYE on these. If they fail, HMRC can issue determinations under Reg 80 and in some cases shift liability to employees under Reg 81.

Employers are legally responsible for deducting, accounting for and paying income tax and Class 1 primary NIC to HMRC under the PAYE system. This article explains the main legal provisions that allow HMRC to transfer this liability from the employer to another person – by means of a personal liability notice, transfer notices or deeming provision.

National Insurance contributions

Under Social Security Contributions and Benefits Act 1992 Sch 1 para 3, employers are initially responsible for paying Class 1 primary NICs. They must deduct these from the employee's earnings, subject to certain deductions that are permitted under Social Security (Contributions) Regulations 2001 Sch 4 para 6(2).

Criminal liability for NIC evasion

Under the Social Security Administration Act 1992 s 114, anyone who fraudulently avoids paying NICs commits a criminal offence. If convicted:

- on indictment (in a Crown Court), they can face up to seven years in prison; or
- on summary conviction (in a Magistrates' Court), they can be fined up to the statutory maximum, which is currently unlimited.

If the offence is committed by a company, and it occurred with the consent, connivance or neglect of a company officer (such as a director), s 115 allows that officer to be prosecuted personally.

Personal liability notices to culpable officers

HMRC may issue a personal liability notice to individual officers of a company – referred to as the culpable officers – if it believes that the company's failure to pay NICs in time was due to fraud or neglect by those individuals. This power is granted under the Social Security Administration Act 1992 s 121C. The personal liability notice can cover the unpaid NICs, as well as any interest and penalties that have accrued or may arise in the future.

This provision means that both the company and the culpable officers are jointly liable for the debt. Any amount paid by one party reduces the liability of the other. This joint liability is set out in s 121C sub-ss (7) and (8). This mechanism is a common feature of personal liability notices and serves as a reminder that individuals in positions of responsibility within a company can be held personally accountable for failures to meet NIC obligations where misconduct is involved.

Where the employer is not liable

If an employer is responsible for paying secondary NICs but fails to pay the primary NICs due for a particular employee, the employer may not be held liable in certain circumstances. This applies where either:

1. the failure to pay was caused by something the employee did or failed to do, and not because of any negligence by the employer; or

2. HMRC is satisfied that the employee knew the employer had deliberately not paid the primary NICs and the employer has not recovered those NICs from the employee.

In such cases, under Social Security (Contributions) Regulations 2001 Reg 86 the employer's liability for the NICs is removed. HMRC can then issue a decision notice under Social Security Contributions (Transfer of Functions, etc.) Act 1999 s 8 to recover the unpaid NICs directly from the employee.

Income tax

Reg 21(1) of the Income Tax (Pay As You Earn) Regulations 2003 requires employers, and other payers (defined in Reg 12). to deduct income tax from

payments of net PAYE income. Tax is calculated after deducting allowable pension contributions and Gift Aid donations. The tax must be deducted using the employee's tax code, if one is available.

Under Reg 185(5), the net tax deducted during the tax year (for self-assessment purposes) includes not only the actual tax deducted but also any tax that should have been deducted but wasn't. This includes:

a) tax that the employer was required to deduct from relevant payments but failed to; and

b) tax that the employer was required to account for under Reg 62(5) (notional payments) but did not.

Thus, employees are generally given credit for PAYE tax that should have been deducted by the employer, even if it wasn't (subject to some exceptions).

Under a Reg 72(5) or Reg 81(4) direction, HMRC will direct that the employer is not liable for the tax that has not been or is not accounted for. This tax is not to be added as tax treated as deducted from the employee under Reg 185(5) (self-assessment) and Reg 188(3) (other assessment) purposes.

Notional payments

A notional payment is a type of payment that is treated as if it were made to an employee for tax purposes, even though no actual money has changed hands. This concept is defined at Income Tax (Earnings and Pensions) Act (ITEPA) 2003 s 710(2).

A notional payment typically arises when an employee receives a benefit or entitlement that is taxable as employment income, but no cash is paid at the time. The employer is still required to calculate and account for PAYE tax on that benefit, even though they cannot deduct it from actual wages at that moment.

Examples include:

- payments made by a third party on behalf of the employer;
- employment-related securities or shares provided to an employee; and
- benefits in kind that are treated as earnings under specific provisions of ITEPA 2003.

This means that if an employer fails to operate PAYE on a notional payment, HMRC can treat that as a failure to deduct tax properly. The employer is still liable to account for the tax, even though no actual payment was made to the employee.

Reg 62 (deductions for notional payments) obliges employers to deduct tax from other relevant payments which are actually made at the same time. The employer must account to HMRC for any amount which it is unable to deduct because actual payments are insufficient.

Shortfall notional payments may only be collected under a Reg 81 determination.

PAYE failure by employer (Reg 72)

Regulation 72 only applies where there has been a failure by the employer to deduct income tax from amounts paid to the employee.

Under Reg 72(5), HMRC can issue a direction notice to both an employer and an employee directing that the employer is not liable to pay income tax that was deductible but which it failed to deduct from the employee's pay – referred to as 'the excess' – if either of two conditions is met.

- **Condition A** is that the employer can satisfy HMRC that it took reasonable care and that the failure to deduct the tax was an error made in good faith.
- **Condition B** is that HMRC believes the employee knew the employer deliberately failed to deduct the correct amount of PAYE tax from their pay.

In either case, the liability for the unpaid tax may be shifted from the employer to the employee.

Under Reg 72A, an employer who has failed to deduct PAYE tax from an employee's earnings can formally request that HMRC issue a Reg 72(5) direction. This direction shifts the liability for the unpaid tax from the employer to the employee, provided the conditions above are met. See ***Cos Systems v HMRC.***

Cos Systems v HMRC

An employer request for HMRC to issue a Reg 72 makes the process mandatory: if an employer makes a valid request and the conditions are satisfied, HMRC must

issue the direction. This was confirmed in *Cos Systems Ltd v HMRC* [2017] UKFTT 168, where the tribunal stated at para [20] that HMRC does not have discretion to refuse a direction once the statutory requirements are met.

Note that there is no equivalent provision in Reg 81 that allows the employer to compel HMRC to issue such a determination. In other words, under Reg 81, the decision to pursue the employee lies entirely with HMRC, and the employer has no right to request or require it.

This distinction is significant for advisers. Under Reg 72A, employers have a statutory route to shift liability to employees in qualifying cases, whereas under Reg 81, they do not.

Unpaid PAYE under Reg 80 determination (Reg 81)

Regulation 81 applies to all PAYE liabilities, including where tax is deducted but not paid to HMRC.

HMRC can issue a Reg 80 determination to an employer when it believes the employer has failed to deduct PAYE tax from payments made to employees or has failed to account for tax on notional payments. This determination can cover more than one employee.

The employer has the right to appeal the determination. It is treated as an income tax assessment on the employer and is subject to the appeal procedures set out in Parts 4 to 6 of the Taxes Management Act 1970.

If the tax assessed under the Reg 80 determination is not paid within 30 days of the appeal deadline (which is 30 days from the date of the notice), HMRC can shift the liability to the employee by issuing a Reg 81 determination, provided one of two conditions is met:

- **Condition A**: HMRC believes the employee received the payments knowing that the employer wilfully failed to deduct the correct amount of tax.
- **Condition B**: The unpaid tax relates to a notional payment that the employer was required to deduct tax from. The definition of ‘notional payment’ is taken from ITEPA 2003 s 710(2)(a), as applied by Regulation 2.

However, if HMRC fails to issue a Reg 80 determination to recover unpaid PAYE from an employer, it cannot then deny the employee credit for that PAYE under the self-assessment system (see *Gayen v HMRC*).

Gayen v HMRC

In *Gayen v HMRC* [2013] UKFTT 127, Dr. Gayen had worked for several hospitals that failed to deduct the correct amount of PAYE tax. He submitted his self-assessment tax return on time, relying on the PAYE system to have accounted for his tax liability. HMRC later issued a closure notice increasing his tax liability and imposed a penalty for late payment.

The First-tier Tribunal found that Dr. Gayen had reasonably relied on the PAYE system and that the under-deduction was not his fault. Crucially, HMRC had not issued a Reg 80 determination against the employer to recover the unpaid PAYE. As a result, the tribunal ruled that HMRC could not then seek to recover that same tax from the employee through self-assessment. The employee was entitled to credit for the PAYE that should have been deducted, even though it wasn’t.

This case reinforces the principle that the PAYE system is designed to relieve employees of responsibility for tax that employers are legally required to deduct. If HMRC does not pursue the employer through the proper channels (such as a Reg 80 determination), it cannot shift the burden onto the employee after the fact.

Special cases: PAYE and NIC liability transfers

Agency workers

Under s 44 of ITEPA 2003, if a worker provides services to a client through an agency and is under the client’s direction, supervision and control, then:

- the worker is treated as an employee of the agency; and
- any payments received are treated as employment income for the purposes of income tax.

Equivalent rules for NICs are found in Social Security (Categorisation of Earners) Regulations (SSCR) 1978 Sch 3.

If s 44 applies, the agency is treated as the employer for PAYE purposes under ITEPA 2003 s 688(1) and PAYE Regs 2003 Reg 10.

Transfer of liability:

- **Fraudulent documents:** If the client provides the agency with a fraudulent document to misrepresent the employment relationship, the client becomes liable for PAYE and NICs.
- **Anti-avoidance:** If a third person sets up an arrangement to avoid treating the worker as an employee, they may be treated as the employer.
- **Personal liability notices:** If PAYE is not deducted, HMRC can issue a personal liability notice to company directors involved in the failure. All directors served with a personal liability notice are jointly and severally liable.

Travel expenses

Under ITEPA 2003 s 338, employees can claim income tax relief for travel expenses incurred for work duties, but not for ordinary commuting. For agency workers, each engagement is treated as a separate employment under s 339A, which may allow more travel expense claims.

The equivalent NIC rules are in SSCR 2001 Sch 3.

Transfer of liability:

- If a client provides a fraudulent document to enable improper travel expense deductions, they may be treated as the employer for PAYE and NICs.
- HMRC can issue personal liability notices to directors of client companies for unpaid PAYE. The NIC equivalent is found in SSCR 2001 Sch 4 para 29Z1.

Managed service companies

MSCs are often used to avoid direct employment. Workers become directors and members of these companies, which are managed by MSC providers. Under ITEPA 2003 s 61D, payments (often dividends) from an MSC to a worker are treated as employment income and subject to PAYE.

The equivalent NIC rules are in the Social Security Contributions (Managed Service Companies) Regulations 2007 (Regs 3 and 4).

Transfer of liability:

Under ITEPA 2003 s 688A and PAYE Regulations Reg 97B, HMRC can transfer PAYE liability to:

- directors or associates of the MSC;
- the MSC provide; and
- anyone involved in setting up the arrangement.

This applies if HMRC believes the PAYE debt is irrecoverable from the MSC. There is a 12 month time limit (under Reg 97D) for HMRC to issue the transfer notice after the relevant demand is made.

NICs liabilities can also be transferred under SSCR 2001 Sch 4.

The intermediaries (IR35) legislation contains similar, albeit more complicated rules, in relation to clients and which are beyond the scope of this article.

In conclusion

Employment income is a key source of revenue and collection pressures are likely to cause HMRC officers to resort to these powers to recover PAYE and NIC debts. Advisers should be aware of this risk when guiding clients with planning and compliance.

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