

Tax explainer: PAYE



Introduction

PAYE (Pay As You Earn) is the UK's system for collecting Income Tax and National Insurance directly from employees' wages. Employers deduct these amounts from employees' salaries before paying them, ensuring that tax obligations are met throughout the year.

Who Pays PAYE?

PAYE applies to:

- Employees who earn above the tax-free Personal Allowance (£12,570 for 2024/25)
- Directors of limited companies who take a salary
- Workers on payroll, including full-time, part-time, and temporary employees
- Self-employed individuals do not pay tax via PAYE; instead, they file a Self-Assessment tax return.

How PAYE Works

Income Tax and National Insurance are deducted from employees' wages each time they are paid. Employers calculate PAYE using HMRC tax codes, which determine how much tax should be deducted.

The employer then pays the deducted amounts to HMRC, along with their own employer's National Insurance contributions.

Understanding PAYE Tax Codes

Each employee is assigned a tax code by HMRC, which tells the employer how much tax to deduct.

Common PAYE tax codes include:

- 1257L – Standard tax code for most employees, allowing the full Personal Allowance (£12,570 tax-free).
- BR – Basic rate tax (20%) is deducted from all earnings (usually applies to second jobs or pensions).
- D0 – Higher rate tax (40%) is deducted from all earnings (typically for high earners with multiple jobs).
- K codes – Used when deductions (e.g., unpaid tax or benefits) exceed the tax-free allowance.

Employees should check their tax codes regularly to ensure they are paying the correct amount of tax.

As well as income tax, National Insurance is deducted through PAYE when payable.

PAYE Payment Deadlines for Employers

Employers must report payroll and pay HMRC by:

- The 22nd of each month (if paying electronically)
- The 19th of each month (if paying by post)
- Smaller businesses with annual PAYE bills under £1,500 per month may be eligible to pay quarterly instead

What Happens if the Wrong Amount Is Deducted?

If too much tax is deducted, HMRC may issue a refund via a P800 tax calculation or through an updated tax code.

If too little tax is deducted, HMRC may adjust the employee's tax code to collect the shortfall over future pay periods.

Employer Responsibilities

- Register as an employer with HMRC and operate PAYE through payroll software.
- Deduct the correct amount of Income Tax and NICs from employees' wages.
- Submit Real-Time Information (RTI) reports to HMRC every time employees are paid.
- Keep payroll records for at least 3 years.

Conclusion

PAYE ensures that employees' taxes are deducted correctly and paid throughout the year. Employers must comply with PAYE regulations to avoid penalties and ensure accurate payroll processing. Contact Parry and Parry for expert payroll management and PAYE compliance advice.