

The abolition of Class 2 National Insurance: Introducing a benefit test into Class 4 National Insurance for the self-employed
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

- 1.1 This consultation document explores an area that is core to the financial well-being of many self-employed individuals. As such, we urge very considerable caution in making any significant changes quickly. In particular, we note that the document suggests the earliest possible start date of April 2017. Given the many issues raised in this paper, we would be concerned if changes were ‘rushed through’ without adequate further consultation or with a lack of publicity for the people affected. In our view a start date of April 2017 would seem to give inadequate time for proper consultation, a proper programme of publicity and education which will be crucial.
- 1.2 This consultation closes shortly after a consultation on closer alignment of Income Tax and National Insurance Contributions (NIC)¹ was completed by the Office of Tax Simplification (OTS). These two projects have a significant degree of overlap and, while this response stands in its own right, we would refer you to our response² to that earlier consultation. We strongly recommend that no further action be taken until the OTS final recommendations are agreed so that these two initiatives might be considered together. We can agree that, in

¹ <https://www.gov.uk/government/consultations/key-questions-published-for-ots-review-on-it-nics/key-questions-on-income-tax-nics>

² <http://www.litrg.org.uk/sites/default/files/files/160104-LITRG-Response-OTS-PAYE-review-FINAL.pdf>

theory, one class of NIC for the self-employed would be simpler but there are so many issues to be addressed.

- 1.3 Given the significant changes in people's working patterns including the increase in zero-hour contracts, holding more than one employment at a time or being employed and self-employed at the same time, we recommend that the whole system of National Insurance (NI) be reconsidered rather than tinkering in certain areas followed by changes in a piecemeal fashion. This is especially important given the ever-increasing numbers of self-employed workers.
- 1.4 In a policy change as significant as this there are likely to be 'winners and losers'. We suggest careful analysis is required to first identify who those winners and losers are likely to be and then to ensure that any disadvantaged or vulnerable groups (for example disabled people and potentially all low-income self-employed people) are not disadvantaged disproportionately.
- 1.5 Clear communication and education through different media channels will be essential so that the self-employed understand the changes and any actions they may be required to take as a result of any changes.
- 1.6 The consultation document makes no mention of losses. At the moment losses for income tax and Class 4 NI purposes may be treated differently.¹ This point requires detailed consideration to ensure taxpayers understand their choices and the potential outcomes of any claims made (see Example 1 in the Appendix).

2 About Us

- 2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.
- 2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the

¹ See Schedule 2 SSCBA 1992.

administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

3.1 *General comments on state benefits for the self-employed*

- 3.1.1 It has long been the case that the self-employed are not able to access the same level of benefits as the employed. The changes proposed here continue to make the contributions payable by many self-employed people slightly less¹ than those paid by their employed counterparts, but without providing them with a similar level of access to benefits. Our response assumes that no increase in the rate of Class 4 NI is being considered.
- 3.1.2 In order to qualify for Class 4 NI credits, the self-employed person would need to have profits of a minimum amount. We are concerned that the self-employed may feel under pressure to fail to claim valid expenses in order to reach that profits threshold and so obtain NI credits. That could affect the individual's claim to other benefits too, for example Universal Credit (UC) (see example 2 in the Appendix).
- 3.1.3 Class 4 NIC are based on the individual's profits that are taxable for the tax year. That could be very different from the amount they actually earn *in* the tax year. For example, an individual might draw up accounts to 30 April 2015 and their Class 4 NI liability for 2015/16 would be based on this. Of course that could be very different from the amount actually earned in the period from 6 April 2015 to 5 April 2016. This is already the case for income tax, but significant education might be necessary to ensure self-employed people understand this concept (since many will be used to paying a flat rate of Class 2 NI that qualified them for such benefits).
- 3.1.4 For example, suppose Laura, who has traded for a number of years, has profits for the year to 30 April 2016 of £20,000. Those profits will be assessed to income tax in 2016/17. She loses a contract in May 2016 that means her profits for the year to 30 April 2017 fall to £4,000. Those profits will be assessed to income tax in 2017/18.

The amount she has actually earned in 2016/17 might be calculated thus:

1/12 X £20,000	£1,667
11/12 X £4,000	<u>£3,667</u>

¹ On the basis that it is proposed that self-employed people will be awarded NI credits on a similar basis to employed people; however, the self-employed would then pay NI at 9% as opposed to employed people who pay at the rate of 12%.

Total £5,334

3.1.5 Thus she has 'earned' £5,334 in 2016/17 but pays income tax and Class 4 NI based on profits of £20,000. This reflects the current position, but Laura may need additional support to understand how her NIC are supporting her entitlement to benefits.

3.1.6 Another potential issue is the proposed quarterly reporting of profits. We are not sure how that will fit in with these proposals but a cohesive approach is necessary.

3.2 **Structure of NIC**

3.2.1 From 6 April 2015 the method of collecting Class 2 NIC has changed and now a further change to the NI system for the self-employed is being proposed. Before any such changes are introduced, we recommend that the whole system should be reviewed to ensure it is fair.

3.2.2 Further, we note that the self-employed have to learn about such changes and adapt to them while running their businesses. These changes distract them from that and again we suggest that any changes be properly considered so that further structural changes are not required in the short to medium term.

3.2.3 If the structure of NI is changed then we do think that some consideration must be given as to the naming of the different classes in order to minimise confusion in the future.

3.2.4 We draw your attention to our response to Question 10 below which demonstrates the current inequity in the NI system.

3.2.5 The questions relating to state benefits are structured around contributory benefits. There will also be interactions with tax credits and UC. For example, an individual was entitled to NI credits¹ before 6 April 2015, where they were in receipt of working tax credit and in possession of a Small Earnings Exception certificate. From April 2015, NI credits are given if they are in receipt of working tax credit and have profits below the small profit threshold. This link between tax credits and NI will need to be considered under the new proposals. In addition we would point out that GOV.UK is not clear on this point.

4 **Responses to specific questions raised**

4.1 ***Question 1: Do you think the government should maintain the existing level of access to contributory benefits? If so, how do you think this should be achieved?***

¹ These credits are generally Class 3 but may be Class 1 if the claimant receives the disability element of WTC.

- 4.1.1 The main contributory benefits currently available by payment of Class 2 NIC are the state pension, contributory Employment and Support Allowance (ESA), Maternity Allowance (MA) and bereavement benefits. We think it is essential that the self-employed continue to have access to these benefits and that they continue to contribute towards them in some way. These benefits provide financial support at a time when the individual is either unable to work or has a limited ability to work. Currently many low-income self-employed people choose to pay voluntary Class 2 contributions to protect their rights to such benefits. Often the alternative might be to suffer financial hardship should they become ill, for example. Indeed the state might otherwise have to offer some support if MA, for example, was not available. Thus the voluntary contributions provide a safety net for those on low incomes and reduce the need for state intervention. On this basis we consider it essential that the self-employed be allowed to continue to contribute towards those benefits.
- 4.2 ***Question 2: This chapter explains the government's approach – a profits test at the Small Profits Threshold in Class 4 NICs – and how this could work for self-employed people with profits above the Small Profits Threshold to determine entitlement to the State Pension, Bereavement Benefit and contributory Employment & Support Allowance. Noting the difference between this and the existing benefit entitlement rules (set out in Annex C), what are your views on this general approach?***
- 4.2.1 We welcome the fact that self-employed people earning between the Small Profits Threshold and the lower profits limit will have NI credits awarded in a similar way to that already afforded to employees earning between the lower earnings limit and the primary threshold.
- 4.2.2 We assume, but would like it to be confirmed, that individuals who have made voluntary payments of Class 2 NI to date will retain their rights to those accrued benefits.
- 4.2.3 The treatment of the employed and self-employed is not the same, though, as can be seen by the following examples that use 2015/16 rates.
- 4.2.4 James is employed and earns £112 per week for 51 weeks of the year. On the last week he earns £100. James would be credited with 51 weeks Class 1 NI credits. In order to make up a full year's contribution record he would have to pay one Class 3 NIC (£14.10).
- 4.2.5 John, on the other hand earns the same amount as James over the year (£5,812). This is below the small profits threshold so he would receive no NI credits. Under current rules he might opt to pay voluntary Class 2 contributions (£2.80 per week or £145.60 for a year); under the proposed rules he would have to pay Class 3 contributions (currently £14.10 per week or £733.20 for a year). Clearly this places him in a significantly less favourable position than an employed person earning the same amount in the tax year.
- 4.2.6 It seems inequitable that John, who is self-employed and contributing towards the UK economy is expected to pay Class 3 contributions at the same rate as someone resident overseas, for example. Perhaps a reform of Class 3 NI needs to be considered at the same

time as the reform of NI for the self-employed. We suggest that anyone with income below a certain threshold might be allowed to contribute at a similar rate to the current Class 2.

4.2.7 We would refer you also to section 4.10 below where we discuss the effect of an individual holding more than one employment/self-employment in the year.

4.3 **Question 3: What are your views on the proposed contributory test in Table 2 A? Can you suggest any alternative contributory tests based on annual profits for:**

a. State Pension?

b. Bereavement Support Payment?

c. Employment & Support Allowance?

4.3.1 Overall we would suggest maintaining the current position as much as possible. For this reason we have no comment on the test relating to the state pension (although see section 4.10.2 below where the taxpayer has more than one employment and/or self-employment).

4.3.2 We note there is an effective doubling in the time that contributions require to be paid or credited in order to qualify for the Bereavement Support Payment. This is a significant change. We recommend that as a transitional measure any individual who would have qualified due to having paid 26 Class 2 NIC in a previous year should remain entitled to the benefit. In addition, for anyone who is self-employed for only part of a tax year, their profits should be annualised to determine eligibility. This is an important payment for those who are bereaved. Given that it appears that more contributions may have to be paid to secure this payment, we wonder whether it may be fair to take into account contributions paid or credited by both the deceased *and* the claimant?

4.3.3 The rules for contributory ESA are more complicated. It is not clear from the table whether the second part of the new proposal is also based on the previous two tax years (*which immediately precede the beginning of the benefit year in which a claim is made*). The section in italics is missing from the proposed new version. We would suggest that the requirement could be significantly simplified. For example, two qualifying years (where qualifying is based on Class 4 profits or suitable NI credits) out of three previously recorded tax years. Again we think profits may have to be annualised in a situation where the individual was only self-employed for part of a year. Where NI payments were overdue, a year could be assumed not to count.

4.3.4 Having said that, we think there are some likely issues with this – for example, the taxpayer may have paid their income tax and NI, but failed to file their tax return. At the moment this causes issues where Class 2 has been paid but the return not filed. We suggest this issue might occur more regularly if payment of Class 4 NI alone counted towards benefits. Another issue arises because at the moment it is possible to have some balancing payments collected via Notices of Coding for a subsequent year. Would these be assumed to be paid?

4.4 **Question 4: To what extent do you think that people – and self-employed people in particular – are sufficiently aware of the existing provisions in the NICs system that**

currently protect entitlement to the State Pension and Bereavement Benefits, namely NI credits and Class 3 voluntary NICs?

- 4.4.1 We think there is a very low understanding and awareness of the NIC system generally. We receive regular queries from the public about all Classes of NIC and often we point out that NI credits may be available: this is something that may not have been considered. In addition, there is a lack of understanding that Class 1 contributions are made on a weekly (or monthly) non-cumulative basis whereas Class 2 contributions are considered on an annual cumulative basis. This is exacerbated by the fact that GOV.UK¹ does not explain this at all.
- 4.4.2 Given the importance of ensuring that people make adequate NIC so that they receive a state pension (hopefully a full one) and so are less reliant on means-tested benefits in the future, we think education has a significant part to play, not only in explaining where credits are available, but also in pointing out the consequences of inadequate contributions being paid or credited. This is even more important now that many spouses will not be able to rely on the contributions record of their spouse in order to increase their pension entitlement.
- 4.4.3 We recommend that all workers be provided with information relating to their NIC record on an annual basis. This might be available as part of the annual tax summary, pointing out any deficiencies and the consequences of that but also pointing out any remedies available to 'boost' that contribution record. We note that details of NI paid might become available through the digital tax accounts: such information will only be useful if the taxpayer understands the implications of the figures shown.
- 4.5 ***Question 5: Do you agree that the government should align voluntary contributions (ie by making Class 3 the only voluntary NICs payment) for the new State Pension for employees and the self-employed? Please give reasons.***
- 4.5.1 We agree, in principle, that there should be parity between the employed and self-employed as regards making contributions towards their benefits entitlement. Having said that, we recognise that there are differences between the Class 1 system and the proposed Class 4 system. In addition, the level of Class 3 NIC is significantly higher than the level of Class 2 NIC that may be paid voluntarily by some low-earning self-employed people at the moment. If the cost of making these voluntary contributions is too high, no such contributions will be paid and the individual may end up more dependent upon means-tested benefits in the future. We draw your attention to the response made to Question 10 below that might assist such low-paid individuals. In addition we refer again to our example of John, at section 4.2.3 above that demonstrates the potential unfairness arising from such an increase in the cost of NIC.
- 4.5.2 If the cost of contributions is to increase significantly, then it needs to be phased in gradually, potentially adding to complexity.

¹ <https://www.gov.uk/national-insurance/how-much-you-pay>

- 4.5.3 We have noted already the main people to lose from this proposed change will be the low-paid self-employed. It would be useful to know how many people are potentially affected. Data¹ produced by the Office for National Statistics suggests that the number of self-employed people is increasing significantly year on year. For such individuals the ability to 'save' for their future is crucial to prevent them becoming dependent on means-tested benefits in the future. Further, since the number of years of contributions required to achieve a full state pension has increased to 35 years, it is crucial that years spent in self-employment enable sufficient contributions to be paid. This would become even more important should there be a further increase in the number of years required to qualify for a full state pension.
- 4.5.4 Making voluntary contributions for employed and self-employed earners the same need not mean Class 3 is the only voluntary NIC payment. There are other groups, for example overseas residents and other non-workers, who might pay such contributions. Perhaps this is something that might be explored further before any decision is taken? In addition, we note that Class 3A contributions may be paid by certain groups at the moment.
- 4.6 ***Question 6: Do you think the government should continue to enable individuals who have not made a contribution via sufficient self-employed profits to access:***

a. Bereavement Support Payment?

b. contributory Employment & Support Allowance?

- 4.6.1 We think it is better to allow individuals to access such benefits by making contributions voluntarily or by providing credits for them. If this were not the case, many individuals would need to rely on means-tested benefits in any case – benefits towards which no contribution might have been made.
- 4.7 ***Question 7: Do you agree that the government should consider facilitating this access through Class 3 voluntary contributions?***

We agree that it should be possible to pay contributions voluntarily, but we have concerns that the current level of Class 3 NIC would be beyond the means of many low-income self-employed people, especially if this means that a self-employed person earning the same as an employed person would have to pay significantly more NI. Further, this would be extending the scope of Class 3 NI. It is not clear whether those entitled to Class 3 credits would automatically qualify for these benefits. Given the question below regarding foster carers we do not think this is the intention and confusion could arise.

- 4.8 ***Access to Maternity Allowance***

Question 8: Do you have any comments on the approaches proposed for Maternity Allowance in this chapter? Do you have any preferences for an approach based on:

¹ http://www.ons.gov.uk/ons/dcp171778_432010.pdf

a. A profits test with optional payment of Class 3 NICs during the 13 week test period (to protect those with low profits or who have no recent profits)

b. Estimated earnings during the 13 week test period

c. (For participating spouses only) The conditions of the existing employment test only

- 4.8.1 Because we favour parity between the employed and self-employed, we were drawn towards option b. that allows a self-employed woman to estimate her earnings over a 13 week period. In practical terms, though, this would be almost impossible as the woman would also have to apportion expenses and so on. This could become subjective and we would always favour an objective test.
- 4.8.2 Accordingly we think that payment of some NIC up front that could later be set against any Class 4 liability is the better solution. If the up front payment is to be based on Class 3 contributions, we agree that it will be necessary to review the number of contributions to be paid if the Class 3 rate stays at around its current level. Further, we note that this would be an extension of the benefits for which Class 3 NI currently entitled the payer. If this were not extended to all individuals who paid Class 3 NI, we think confusion would arise. We would also draw your attention to our response at section 4.2.6 above where we suggested that perhaps a reform of Class 3 NI needs to be considered at the same time.

4.9 **Question 9: Can you suggest any alternatives?**

- 4.9.1 It might be possible to base entitlement on attainment of a certain profit level in the prior tax year.

4.10 **Those with multiple sources of earnings**

Question 10: Do you have any comments on the proposals to provide for individuals moving into and out of self-employed within the tax year, who may be less able to achieve annual profits at the Small Profits Threshold?

- 4.10.1 We think this is an area that requires significant further investigation, not only for the self-employed but for the employed too. The OTS paper¹ raised questions about placing NIC on an annual and cumulative basis. There may be merit in this for people with more than one job, whether they be employed, self-employed or both.
- 4.10.2 At the moment, for example, an employee with two part-time positions, each paying £5,000 per annum is unlikely to pay or be credited with NIC whereas a self-employed person with two different self-employments would have the two positions combined and would have to pay Class 2 NIC. The table below highlights such anomalies that seem totally illogical.

¹ <https://www.gov.uk/government/consultations/key-questions-published-for-ots-review-on-itnics/key-questions-on-income-tax-nics>

Type of work	Income level	National Insurance Contributions payable?
One employment	£10,000	Yes
One self-employment	£10,000	Yes
Two employments	Each £5,000	No, probably ¹
Two employments	One £6,000 One £4,000	No, but likely to accrue NI credits No
Two self employments	£10,000 in total ²	Yes
One employment	Pays £6,000	NI credits
One self-employment	Pays £4,000	No NI
One employment	Pays £4,000	No
One self-employment	Pay £6,000	Class 2 NI payable

4.11 *Impact on 'special groups' of Class 2 NICs payers*

Question 11: For the following groups:

- **Share fishermen**
- **Volunteer Development Workers**

Do you have any comments on the proposed approach?

4.11.1 We are unable to comment on the proposals for share fishermen other than to query why an entitlement to contributory JSA is being removed after specific inclusion, when the rationale for inclusion remains. Without seeing profiles of claims made and reported earnings we cannot comment further.

4.11.2 We cannot comment, other than to note that this might dissuade some people from volunteering in this way. This could be a significant loss to the charities involved and national efforts at overseas development.

¹ Currently Class 1 NIC are payable on a weekly basis. It is possible that the individual may have earned more in certain weeks and so have paid or been credited with NIC.

² All self-employments are combined for the purposes of NI.

4.12 **Question 12: For the following groups:**

- ***Self-employed abroad***
- ***Employed abroad***
- ***Mariners on foreign flagged ships***

Do you have any comments on the proposed approach?

4.12.1 We are unable to comment on the proposals.

4.13 **Question 13: For the following groups**

- ***Examiners***
- ***Ministers of Religion***
- ***Foster carers***
- ***Some landlords***
- ***Self employed women with a reduced rate election***

Do you have any comments on the proposed approach?

4.13.1 While we note that foster carers receive NI credits, these are Class 3 credits and do not provide the same level of benefits as payment of Class 2 NIC. These individuals, who play a significant role in assisting the country's most vulnerable young people, are being denied the ability to qualify for contributory ESA or MA. We cannot agree that is satisfactory.

LITRG
22 February 2016

Appendix

Example 1

Currently losses for Class 4 NI purposes can be treated differently from the income tax losses to which they attach.

In a simple case, a trader makes a loss in the year to 31 March 2016. He elects to set that loss against his other income for that year *for income tax purposes*. He can carry the Class 4 loss forward against his future earnings from the trade, however.

Under current rules that would mean he would have no obligation to pay Class 2 NIC for the year to 31 March 2016 (although he could choose to pay voluntary contributions). It is likely he would be liable to pay such Class 2 NIC for future years.

These proposals do not make it clear what would happen if Class 4 became contributory. Assuming the new rules were in place it would seem clear that he would not have to pay Class 4 NIC for the year to 31 March 2016. The potential carry-forward of losses for Class 4 NI purposes to the year to 31 March 2017 might mean he also had no liability for that year. Thus his future entitlement to state benefits might be restricted.

Example 2

Laura claims UC and so obtains Class 3 NI credits. She is also self-employed and used to pay Class 2 NIC, either due to her profit level or, if her profits were insufficient to require such payments, because she wanted to maintain eligibility to contributory ESA and MA.

In the year to 31 March 20xx, she takes on a contract that takes up much more of her time than anticipated and her profits fall. When she looks at draft figures in March, she finds that her profits for the year are below the level where she would be entitled to Class 4 credits, but if she did not claim as an expense the cost of the flights she had to take to visit the headquarters of one of her clients, her profits would just fall into the bracket where she would obtain Class 4 credits.

In this situation, Laura might choose not to claim the expense as a deduction for income tax purposes, enabling her to obtain Class 4 credits, although normal accounting principles would suggest the expense should be claimed. This would be more cost-effective for her than paying voluntary Class 3 contributions. There seems to be no reason why she might not claim this as a valid expense for UC, though. Of course any interaction with the Minimum Income Floor might also be considered.