Simplifying the National Insurance Processes for the Self-Employed

Consultation document

Publication date: 18 July 2013

Closing date for comments: 9 October 2013

Subject of this consultation:	This consultation looks at the option of collecting Class 2 National Insurance Contributions (NICs) alongside Class 4 NICs and income tax through the Self Assessment process.
Scope of this consultation:	No decisions have been taken that commits collecting Class 2 NICs through Self Assessment. This consultation seeks to test whether collecting Class 2 NICs alongside income tax and Class 4 NICs would be simpler and reduce the administrative burden on the self-employed community.
Who should read this:	Self-employed people, agents who act on the behalf of self-employed people and bodies that represent self-employed people.
Duration:	18th July 2013 to 9th October 2013
Lead official:	Samantha Tennakoon HM Revenue & Customs (HMRC) 100 Parliament Street Room 1E/17, 100 Parliament Street London SW1A 2BQ Telephone: 0207 147 0582 Email: consultation.nic@hmrc.gsi.gov.uk
How to respond or enquire about this consultation:	Responses can be made to Samantha Tennakoon at the above postal or e-mail address.
Additional ways to be involved:	In order to engage interested parties as widely as possible with the consultation we would be happy to meet with representative bodies, agents and individuals. Please use the contact details above if you wish to arrange such a meeting.

After the consultation:	A summary of responses will be published at Autumn Statement and an update of this work will be given at that time.
Getting to this stage:	The Office for Tax Simplification recommended in their *Review of Small Business* in 2012 that the Government review the NICs processes for the self-employed and look at collecting Class 2 NICs through the Self Assessment process.
Previous engagement:	HMRC have held discussions with a small number of self-employed people to understand their experience of the current system. These were informal discussions and not formally documented.

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Foreword

Self-employment enables a wide range of people to make a positive and fulfilling contribution to the economy, with self-employed individuals often playing a key role in driving growth by introducing new ideas and innovations.

The Government is keen to minimise the barriers that hinder those who want to start and run their own business. It recognises that complying with the tax system imposes costs, and is committed to creating a simple, transparent and fair tax system for all. We have already taken several steps towards this by setting up the Office for Tax Simplification (OTS), introducing simplified expenses and the cash basis accounting system for small businesses, and are committed to enabling individuals and businesses to engage with HMRC digitally.

In their 2012 Review of Small Business the OTS recommended that the Government review the National Insurance processes for the self-employed and, in particular, recommended collecting Class 2 National Insurance contributions (NICs) through the Self Assessment process. The Government agreed with this recommendation, and announced at Budget 2013 that HMRC would consult on this proposal.

The aim of this consultation is to engage self-employed individuals and those that represent them on collecting Class 2 NICs through Self Assessment alongside income tax and Class 4 NICs. We are keen to seek views on whether this change would lead to a simpler, more straightforward system. This would not increase or reduce NICs liabilities for the self-employed, but will hopefully reduce the administrative burdens of paying Class 2 NICs.

I hope you will engage as fully as possible with the options HMRC have set out in this document, and help us to introduce changes that simplify the NICs system for the self-employed.

I would like to thank you for your support in this consultation.

David Gauke
Exchequer Secretary to the Treasury
July 2013

1. Introduction

1.1 Today's employment patterns are very different from those that existed when the present design of the National Insurance system was introduced almost forty years ago. Whilst some people remain self-employed over the majority of their working life, others may be in and out of self-employment (because of seasonal work or because their employment contracts vary from job to job) and some people may have self-employment income in addition to employment income. There is also a growing trend of people taking on self-employed work late in their working life to take advantage of the control and flexibility that self-employed work can give.

1.2 The make-up of the self-employed population is also very broad. The Office for Tax Simplification (OTS) describes three customer groups[1]:

- individuals with self-employed income from occasional activities such as writing, consultancy, internet-based trading, lecturing or home tutoring;
- part-time and full time workers such as hairdressers, shopkeepers, beauticians, child minders, medical consultants, taxi drivers, journalists, IT consultants, engineers, builders; and
- individuals or partnerships that run larger businesses that employ staff such as manufacturers and professional firms of solicitors, architects.

1.3 It is against this context that we consider whether collecting Class 2 NICs through the Self Assessment (SA) system, might better suit current working patterns and overall make for a simpler system.

1.4 Reviewing internal data and feedback from customers has given HMRC some insight into customers' experiences of the Class 2 processes. Given that the nature and pattern of self-employed work is diverse, a person's individual circumstances will affect the experience of paying National Insurance Contributions (NICs). The following two paragraphs identify two broad groups who because of their pattern of work may have differing experiences of fulfilling their NICs obligations:

[1] *A Simpler Income Tax for the Smallest Business: a discussion paper*, Office for Tax Simplification, July 2011

Predominantly self-employed (stable, regular, predictable)

1.5 If you are someone who is long-term self-employed with profits above £5,725[2] and no other job, with a direct debit in place, then the Class 2 process is probably quite straight-forward. You usually set up a direct debit at the point of registration and require very little ongoing interaction with HMRC regarding payment of Class 2 NICs. Class 4 NICs will be paid alongside your income tax as part of the SA process. It is worth noting that whether or not the individual makes a profit they are required to fill in an SA return.

Short-term/part-time self-employment (changes of circumstances, irregular, unpredictable)

1.6 If you are in and out of self-employment, are concurrently self-employed and employed or have low or fluctuating profits, the system requires far greater contact between the customer and HMRC:

- You need to notify HMRC if you are no longer self-employed and if you start up again, you will need to register again as self employed for payment of Class 2 NICs;
- You may have decisions to make as to whether you defer your Class 2 and Class 4 payments if you think you may pay sufficient Class 1 contributions to meet the maximum you need to pay in a year;[3]
- You may also have to decide whether you apply for a Small Earnings Exception (SEE) if you are forecasting low profits, and if you continue to have low profits, you will have to re-apply for your exception certificate every three years.

1.7 The OTS Review of Small Business specifically identified the SEE processes and the deferment process as driving particular complexity within the NICs system. The fact that Class 2 NICs is calculated and paid in-year before the total level of earnings from any self-employed or employed work is known is the main reason for

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[2] Individual who have profits below a Small Earnings Exception (SEE) Limit can apply to HMRC for an exception to pay Class 2 NICs. The SEE limit for 2013-14 is £5,725

[3] The annual Class 1 and 2 NICs maximum limits the amount of Class 1 and 2 NICs payable by any earner who holds more than one employment. Without a limit, individuals with more than one employment could pay far more National Insurance than is necessary to secure full benefit entitlement and far more than a person who earns the same amount but from a single employment (see paragraphs 51-54 in Annex A for more detail).

these additional processes. This can add further administrative burden for some at the end of the tax year. These processes are discussed in more detail in Chapter 2.

1.8 HMRC has held informal discussions with self-employed people to understand first-hand their experience of the Class 2 NICs system. These have highlighted that the current system can be confusing for some customers and knowledge about how the current rules and processes operate is patchy. For example some customers did not know the difference between Class 2 and Class 4 NICs and thought that by paying NICs (Class 4) through SA they were fulfilling their NICs obligations and securing entitlement to benefits. Some assumed that you don't have to pay Class 2 NICs if you have low profits (i.e. that the exception from payment is automatic) with little awareness of the SEE process. Other points of confusion were around the circumstances in which you could claim refunds or defer the payment of Class 2 NICs. Class 2 debt collection activity has also shown that many people do not tell HMRC when they cease self-employment which can lead to the build-up of Class 2 debt.

1.9 Given that nearly all self-employed people need to complete an SA return, the OTS recommends that the calculation of Class 2 NICs becomes part of the SA process to modernise the way that Class 2 NICs is assessed and collected to deliver administrative benefits for small business. In their *Review of Small Business* (2012), the OTS concluded that, 'it could save HMRC and small unincorporated businesses costs if the Class 2 contributions were brought within the SA process in the same way as Class 4 contributions.'[4]

1.10 This consultation document seeks views on whether collecting Class 2 NICs through the SA process, alongside Class 4 NICs and income tax would be a simpler, more straight-forward system for customers.

Chapter 2 briefly summarises the issues with the current system. Details of the current rules and processes for Class 2 and Class 4 NICs are included at Annex A.

Chapter 3 discusses the option of collecting Class 2 NICs through the SA process.

Chapter 4 considers the impact of the proposition on claims to Social Security benefits.

[4] Office for Tax Simplification Small Business Review Final Report: HMRC Administration, page 38 (2012)

Chapter 5: Whilst the scope of this consultation focuses on collecting Class 2 NICs through SA, this chapter seeks views on whether there are any other areas for change that could deliver further simplification.

1.11 When considering the scope for change it is worth bearing in mind that HMRC is embarking on a digital transformation of its services. This opens up significant opportunities to improve the way that small business can engage with HMRC for all their tax and NICs affairs. Therefore HMRC wants to test at the outset whether the collection of Class 2 NICs should be part of the SA process and as such be within the scope of process improvements to the SA system as part of HMRC's digital agenda.

2. The Current System

Background

2.1 There are around 4.4m self-employed customers who may be liable to pay income tax and NICs. The self-employed pay two types of NICs - Class 2 NICs and Class 4 NICs. Employees pay Class 1 NICs. Some individuals who are both employed and self-employed will pay Class 1, Class 2 and Class 4 NICs up to a maximum amount. A brief description of the different aspects of the NICs system referred to in this chapter is included below (all rates referred to apply to 2013-14):

Class 1 NICs[5] are an earnings related liability paid by employees and their employers and are deducted by the employer through the payroll. They provide access to the full range of contributory benefits.

Class 2 NICs[6] are a flat rate liability of £2.70 a week which gives the self-employed access to a narrower range of contributory benefits including Employment and Support Allowance, bereavement benefits, basic state pension, and the standard rate of Maternity Allowance. Class 2 NICs are collected through a stand-alone process using six monthly bills or direct debit.

Class 3 NICs are a flat rate voluntary payment of £13.55 a week which gives those who have gaps in their contribution record an opportunity to protect their access to basic state pension and bereavement benefits.

Class 4 NICs[7] are a profits related liability payable on annual taxable profits. This is collected through the Self Assessment (SA) system alongside income tax and does not count towards the individual's contributory benefit position.

NI Credits: Some people are eligible for NI Credits which can give the equivalent eligibility to a Class 1 or Class 3 payment.

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[5] For the tax year 2013-14 employees pay 12% on earnings between the Primary Threshold of £149 (annual equivalent £7,755) and the Upper Earnings Limit of £797 (annual equivalent £41,450) and 2% on earnings above that. Employees that have earnings at or between the Lower Earnings Limit of £109 (annual equivalent £5,668) and £149 do not pay Class 1 NICs but are treated for contributory benefits as having paid Class 1 contributions.

[6] See paragraph 17 in Annex A for details on how Class 2 NICs are paid.

[7] See paragraphs 39-50 in Annex A for further information on Class 4 NICs

2.2 The OTS Review of Small Business identified two particular processes that drive complexity within the Class 2 NICs system; the Small Earnings Exception processes and the deferment process. These are discussed in turn below:

Small Earnings Exceptions (SEE)

2.3 Anyone who anticipates that their annual profits from self-employment will fall below an annual threshold can apply for exception from paying Class 2 NICs. The threshold is referred to as the Small Earnings Exception (SEE) limit and is set annually. For the tax year 2013/14 the SEE limit has been set at £5,725.

2.4 A self-employed person who wishes to be exempt must apply to HMRC for SEE. Subject to satisfying the conditions, HMRC will grant the person an exception to pay and issue a certificate of Small Earnings Exception. A SEE certificate can be backdated for a maximum of 13 weeks from the point of application or to the start of the tax year (whichever is the shorter).

2.5 The SEE process is based on anticipated profit levels. This can result in further contact with HMRC if the actual profits do not then match the anticipated profit levels. This is illustrated by the example on the next page:

John anticipates profits above the SEE limit and pays Class 2 NICs throughout the year. At the end of the tax year John finds that he has made profits below the SEE limit and decides to apply to HMRC for a refund of the Class 2 NICs he has paid. He has to provide evidence of his profits. John applies for a refund within the time-limits, HMRC approves his application and John gets a refund of the Class 2 NICs that he has paid.

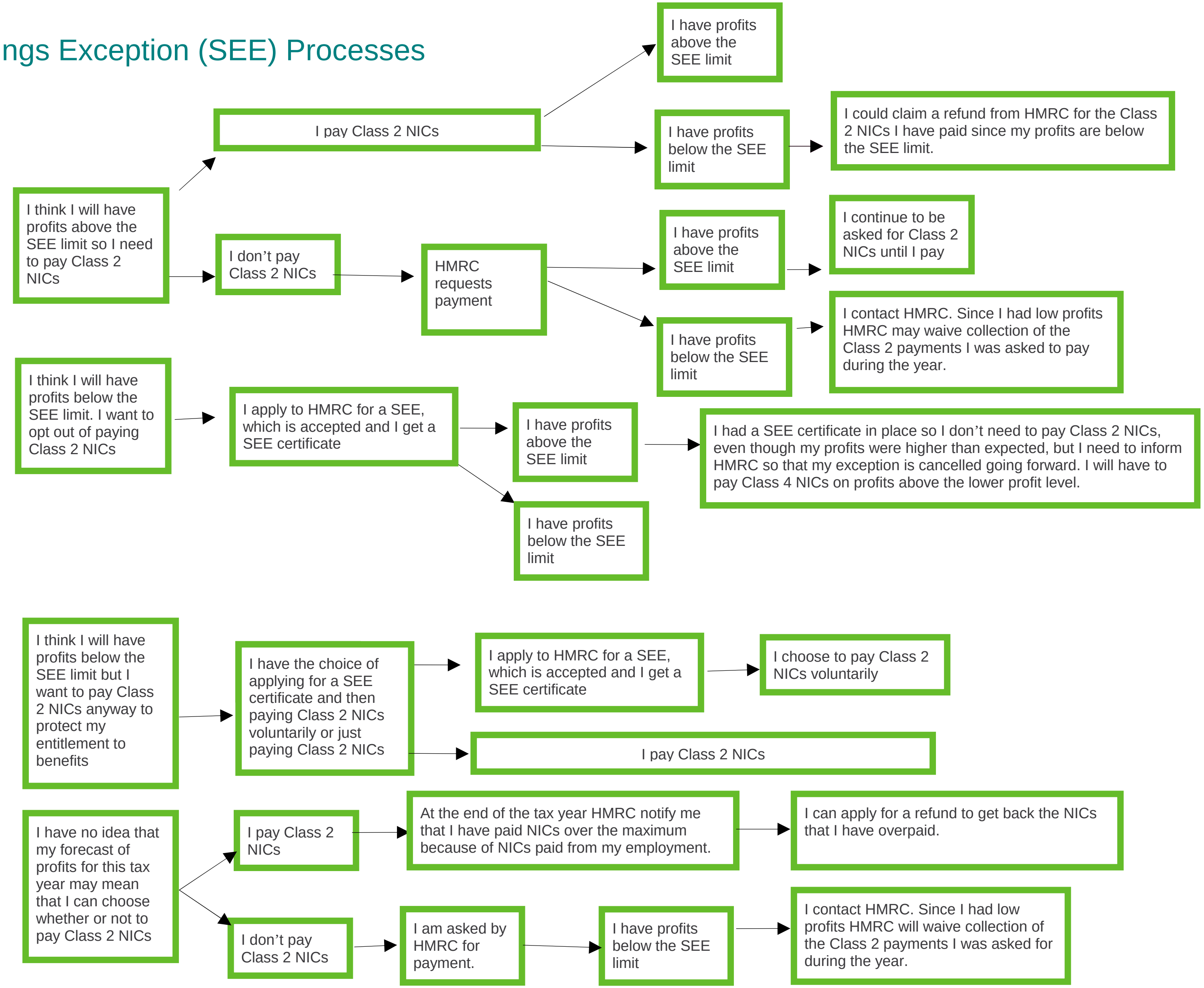
Jake on the other hand expected low profits and applied to HMRC for a SEE. HMRC approves Jake's SEE application and issues Jake with a SEE certificate. Jake doesn't pay any Class 2 NICs. At the end of the tax year Jake finds that he has made profits above the SEE limit. Because Jake had a SEE in place he is not required to pay any Class 2 NICs for the past periods. However Jake is required to inform HMRC who will cancel his SEE certificate going forward and Jake commences Class 2 NICs payments.

2.6 Informal feedback from customers indicates a low awareness of the SEE process and shows that some think that the SEE is an automatic process – i.e. if they have low profits they don't need to pay Class 2 NICs.

2.7 Only around 300,000 people hold a SEE certificate at any given time. About 800,000 people have low profits and pay Class 2 NICs but out of this group around 500,000 also have earnings from employment. This may mean that they are already covered for contributory benefits and could apply for SEE without any detriment to their benefit position.

2.8 The flow chart on the following page shows the complexity of the current system and the range of steps that people might take depending on the level of profits anticipated and the actual level of profits made.

Small Earnings Exception (SEE) Processes



Deferring payment of Class 2 NICs

2.9 Some people who are employed and self-employed can apply to HMRC to defer paying their Class 2 NICs. There is a maximum amount of NICs an individual is liable to pay across Class 1, Class 2 and Class 4 NICs. Individuals who think they might exceed this maximum can choose to defer payment of NICs until the end of the year.

2.10 The individual can request deferring Class 2 payment from HMRC via a paper application form. However individuals who expect to have profits below the SEE limit are requested not to apply for Class 2 deferment and instead apply to HMRC for a SEE certificate. A proportion of individuals however wait until the end of the year and request a refund of any NICs overpaid in the year instead.

2.11 At the end of the tax year HMRC will complete an annual reconciliation to calculate whether the individual has paid NICs up to the annual maximum. If they have not, the individual will be sent a request to pay the outstanding balance of NICs that they have deferred. Anyone who has paid Class 2 NICs over the year rather than defer payment will be asked to apply for a refund of Class 2 and 4 NICs as appropriate, if they have paid over the annual maximum.

2.12 Deferment of NICs can only be made for one year at a time. If an individual expects to exceed the annual maximum in subsequent years, then they currently need to apply to HMRC and renew their deferral to pay Class 2 NICs each year. Where deferment has previously been granted, HMRC automatically issues a renewal application to the individual.

Administrative burdens for small business and HMRC

2.13 The processes for SEE, deferment and Class 2 NICs refunds drive significant administrative burdens on small business. Self-employed people also have to interact with different parts of HMRC, follow separate rules and use separate payment processes to fulfil their Class 2 and Class 4 National Insurance obligations.

2.14 In recent years HMRC has taken steps to align the Class 2 NICs and SA process to make interaction with HMRC easier for small business. For example since April 2012 a self-employed person can register for tax and NICs at the same time through the Online Tax Registration Service (OTRS), which will register the individual for SA and Class 2 NICs. In 2011 HMRC moved the collection of Class 2 NICs from quarterly billing to six monthly payment dates and aligned the direct debit payment dates with the SA payment on account dates[8]. Whilst this means some individuals could consider the payment of Class 2 NICs and SA liability at similar points in the year, they would still need to send two separate payments to HMRC.

2.15 Class 2 NICs account for less than 0.3% of the £102bn NICs collected by HMRC in 2012/13 and yet accounted for around 40% of NI related telephone calls to HMRC and associated processing work. The Class 2 NICs processes generate around 6.5 million paper outputs each year including: payment requests, direct debit statements, SEE applications and certificates etc, and generates inbound post of 1.8 million.

Class 2 Debt

2.16 At October 2012 the total Class 2 debt balance stood at £984 million. However initial analysis suggests a significant proportion of this debt may not actually be due when the cases are examined individually. This is because some of the Class 2 debt relates to those who have ceased self-employment or registered as self-employed with HMRC but never started their self employment and have not notified HMRC. It also includes those individuals who, whilst liable to pay Class 2 NICs, would have been eligible to SEE, but did not apply. This section summarises how the current processes can inadvertently lead to the build up of Class 2 debt.

2.17 As soon as a person stops being self-employed their liability to pay Class 2 NICs ceases. Class 2 NICs are a weekly liability and so the individual is required to inform HMRC as soon as they cease trading as they no longer need to pay Class 2 NICs. Some customers do not notify HMRC until they complete their SA Return, which can be up to 21 months later. Until the individual informs HMRC that they have ceased trading, HMRC will still consider the individual to be liable to pay Class 2 NICs and will accrue debt on the individual’s account when no payment is made. As individuals may be concurrently employed and self-employed, it is not possible to infer that self-employment has ceased. This can lead to the individual being asked for payments that they do not owe which can cause unnecessary confusion and worry.

2.18 The current Class 2 processes can drive complexity for small business for a number of reasons. Those who engage with the SEE and deferment processes can

[8] Individuals with SA liability (income tax and Class 4 NICs) greater than £1,000 are required to make ‘payments on account’ (interim payments) by the 31st July and 31st January.

find them particularly confusing and convoluted. The cost of administering Class 2 NICs in this way is not efficient or cost-effective for the customer or HMRC and can require the individual to have several interactions with HMRC over the course of the year and after the end of the year if their circumstances change or if their forecasted profits are not as expected. This can lead to the individual completing further paperwork to ensure they pay the right amount of Class 2 NICs.

2.19 It is this feedback from customers together with the OTS and HMRC's analysis that suggests that collecting and reporting both income tax, Class 2 and 4 NICs for the self-employed through a single system could offer benefits to our self-employed customers. The Government therefore announced at Budget 2013 that HMRC would consult on collecting Class 2 NICs through the SA process.

3. Simplifying Self-employed NICs: Collecting Class 2 NICs through Self-Assessment

Introduction

3.1 Chapter 2 highlights some of the issues that customers experience under the current system. This chapter discusses the option of ending the collection of Class 2 NICs by direct debit and six monthly billing and collecting Class 2 NICs through Self Assessment (SA) and seeks views on whether this would be a simpler way for self-employed customers to pay the Class 2 NICs that are due.

The SA system

3.2 The SA system assesses liability to pay income tax and Class 4 NICs after the end of the tax year. When an individual becomes self-employed they are required to notify HMRC and register for tax and NICs. They can do this through the Online Tax Registration Service (OTRS) which currently registers the individual for SA and the payment of Class 2 NICs in-year.

3.3 After the end of the tax year, the individual will receive a notice to file an SA Return which is generally issued in April. The individual will have until the 31st January in the following calendar year to pay the SA liability that is due. This amount will include the income tax and Class 4 NICs that are due. For example for the 2013-14 tax year, an individual will receive a notice to file in April 2014. If filing on-line the SA Return and the SA final payment are due by the 31st January 2015. If the individual's SA liability is more than £1,000 they will also make an interim payment towards the next year's SA liability (2014-15 tax year), with a second interim payment due by the 31st July 2015. The SA Return for the 2014-15 tax year and final balancing paying is due by the following 31st January 2016.

Collecting Class 2 through Self Assessment – how the new process might look

3.4 The additional administration associated with the SEE and deferment processes result from Class 2 NICs being paid in year before the level of profits from self-employment and earnings from any employment are known (if the individual is also employed). This suggests that collecting Class 2 NICs after the end of the tax year might administratively be simpler than the current system. The following paragraphs consider at a high level how collecting Class 2 NICs through SA could operate.

3.5 After the end of the tax year the individual would receive a notice to file their SA return, which would be due by 31st October if filing a paper return and by the following 31st January if filing online. When an individual completes their SA Return, they will be asked for a start date and an end date of their self-employment (if these are not completed the system will assume that the individual has been self-employed for the full tax year). They could also be asked on the return whether they want to apply for the small earnings exception if their profits are below the SEE limit. The SA system could calculate the amount of Class 2 NICs due based on the number of weeks the individual has been self-employed.

3.6 The Class 2 NICs liability will be added to the individual's total SA liability and will be due by the SA final payment deadline. Once the SA Return is filed, payments against the final liability could be made at any time from the point of filing the SA Return to the 31st January following the end of the relevant tax year.

3.7 HMRC expects that the individual would be able to see the amount of Class 2 NICs due separately on the SA statement and the amount would be added to the total SA payment due. When the individual makes their SA payment, the Class 2 element would still be accounted for separately to enable HMRC to update the individual's contribution record to show that Class 2 NICs has been paid for the relevant tax year.

3.8 The process outlined above simplifies the system because it considers Class 2 NICs liability after the end of the tax year, when the individual's profits are known, rather than during the year when the level of profits for the year is anticipated. This gives the opportunity to remove the SEE processes and build these aspects into the SA process, giving greater certainty for the customer.

3.9 For example if an individual reports profits below the SEE limit, they could opt-out of paying Class 2 NICs. This could be prompted through the SA calculation process. If they choose not to pay Class 2 NICs, then there would be no Class 2 NICs to pay. As occurs today the individual would need to be alerted to the potential impact on benefit entitlement if they opt out.

3.10 Additionally because the Class 2 NICs liability will be calculated after the end of the tax year when the self-employed person files their SA Return, the timing means that the total amount of any Class 1 contributions made during that year will be known. This could offer the opportunity to explore how the annual maximum calculation could form part of the SA calculation allowing the Class 2 deferment process to be removed.

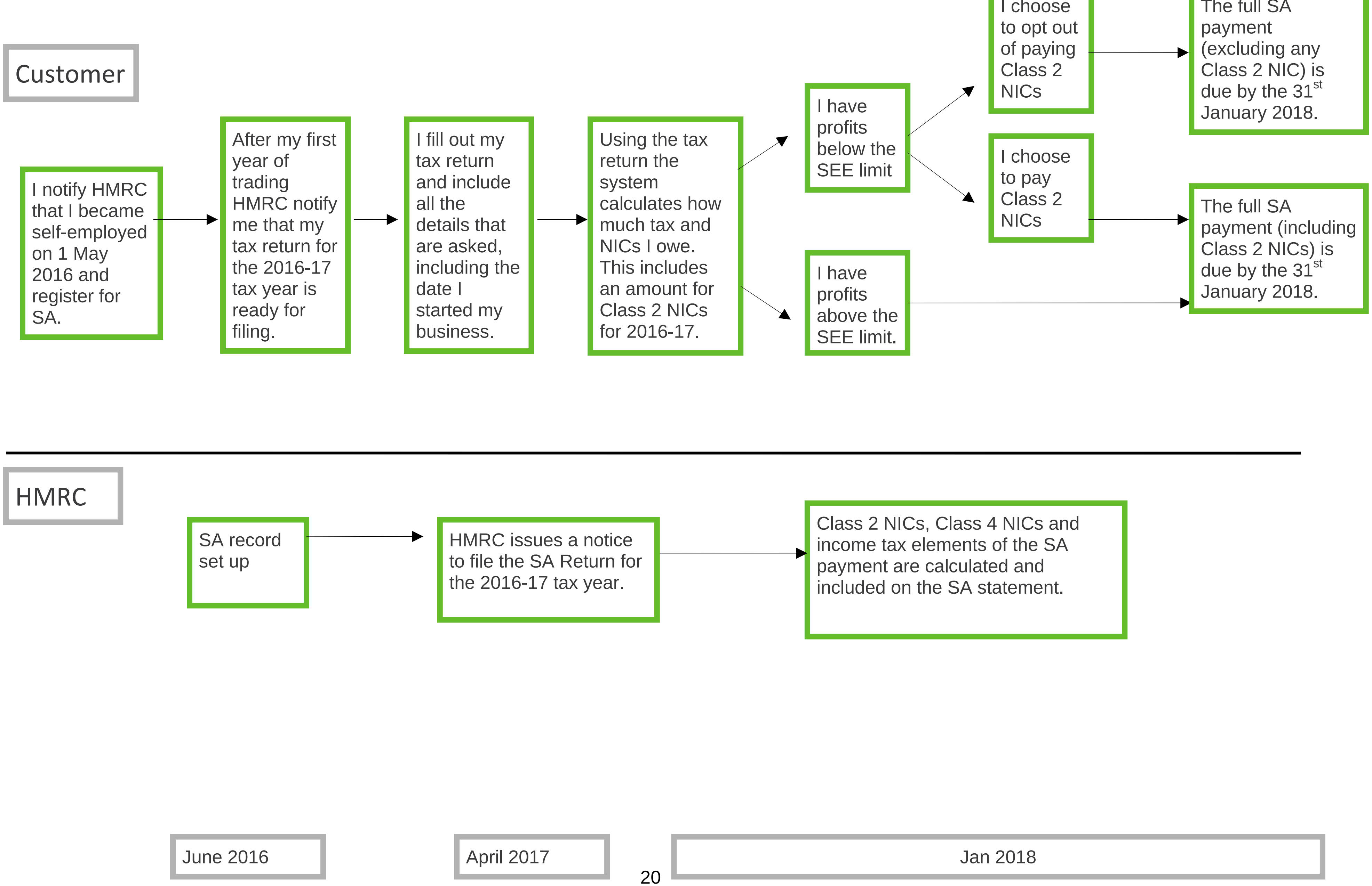
3.11 Collecting Class 2 NICs after the end of the tax year would give the opportunity to remove the SEE and Class 2 deferment processes, which could deliver significant administrative benefits for some self-employed people. It would also remove the need for self-employed people to inform HMRC if they stopped and started self-employment during the year as their Class 2 liability would be calculated after the end of the tax year. For customers who currently pay Class 2 NICs there will need to be a period of transition as people moved from the current method of paying Class 2 NICs to paying Class 2 NICs through SA.

3.12 To avoid difficulties that might otherwise arise by collecting Class 2 NICs for individuals who may need to claim Maternity Allowance (MA) or Employment and Support Allowance (ESA) during certain months of the year, HMRC expects that the current exceptions process could be expanded for the minority of people who might be affected by this change. This is discussed in Chapter 4.

3.13 The following page shows the journey self-employed people could go through to pay Class 2 through SA.

Collecting Class 2 NICs through the Self Assessment Process

The only step that the individual needs to do in addition to the steps they go through today in the SA process is the decision whether to opt out of paying Class 2 NICs if their profits are below the SEE limit. The processes of applying for a SEE exception, receiving a SEE certificate and deferring payment of Class 2 in-year would be removed.



UK self-employment with overseas involvement

3.14 There is a small group of people who are normally self-employed in the UK but who remain liable for Class 2 NICs when they are working abroad temporarily. There are also some people living abroad who are self-employed in the UK and so liable for Class 2 NICs. Depending on their circumstances these self-employed workers may not be required to complete an SA Return if they have no UK income tax or Class 4 NICs liabilities. HMRC expects to maintain an exceptions process to enable these customers to pay their Class 2 NICs liability since they are not required to submit an SA Return.

Class 2 NICs and special groups

3.15 There are different rules for certain special groups who do not report self-employed income through the SA process. These groups include share-fishermen, mariners and volunteer development workers. There are no plans to remove any of the different rules that apply to these groups.

Questions

Q1a) Overall would collecting Class 2 NICs through the Self Assessment system be simpler?

Q1b) What benefits do you think this could bring to customers?

Q1c) Do you see any drawbacks?

Q2) What do you consider will be the transitional challenges of moving from the current system to collecting Class 2 NICs through the SA system?

4. Impact on Claiming Social Security Benefits

4.1 This chapter looks at the impact of collecting Class 2 NICs through the Self Assessment system on the contributory benefits claims processes. Class 2 NICs builds entitlement to Maternity Allowance (MA), Employment and Support Allowance (ESA) and State Pension and also interacts with Universal Credit.

Employment and Support Allowance (ESA)

4.2 ESA requires the individual to have paid sufficient NICs contributions in the two complete tax years preceding the benefit year in which the claim is made. The benefit year runs from the first Sunday in January in any calendar year to the Saturday immediately preceding the first Sunday in January of the following calendar year. If Class 2 NICs were collected through SA after the end of the tax year, the deadline for making the SA payment would be the 31st January after the end of the tax year - a few weeks after the relevant benefit year has started. Individuals can, however file their SA return and pay their Class 2 NICs earlier. Under the new process, anyone who made a claim for ESA may not have paid the NICs due to meet the current qualifying conditions. In reality we expect relatively small numbers of self-employed individuals would seek to make a claim for ESA in the few weeks between the first Sunday in January and the 31st January.

4.3 The individual would need to complete and file an SA return to determine liability to pay Class 2 NICs. Once the SA return has been filed the current SA system allows individuals to make payments against their SA liability ahead of the SA payment deadline date. As the Class 2 NICs element would be shown separately on the SA statement, the individual making a claim in the weeks between the first Sunday in January (the start of the new benefit year) and 31st January (the SA final payment deadline) could file their SA return and pay the Class 2 NICs ahead of their SA payment deadline date to meet the qualifying conditions for ESA. The current late payment rules may need to be amended.[9]

[9] See paragraphs 21-22 in Annex A for further details on current late payment rules.

Maternity Allowance (MA)

4.4 Out of a self-employed population of approximately 4.4m, around 25,000 self-employed women claim MA each year. Entitlement to MA is not assessed on self-employment and Class 2 NICs paid in a particular benefit year; instead it is assessed over a test period of 66 weeks up to and including the week before the week the baby is due.

4.5 There are two levels of MA that a self-employed woman can receive:

Standard rate: To be entitled to the standard rate of MA the woman needs to satisfy two conditions. She must be self-employed for at least 26 weeks during the test period and also have paid 13 weeks worth of Class 2 NICs within the test period.

Lower rate: This is dependent on the woman being self-employed for 26 weeks within the test period and having earnings to the equivalent of £30 a week on average. Under current rules if a woman holds a SEE certificate, she will be treated as earning at this level and will only be eligible for the lower rate of MA.

4.6 Collecting Class 2 NICs after the end of the tax year could impact some of the 25,000 women who are reliant on Class 2 NICs paid within that current tax year; for example a woman who needs to claim MA in December 2016 and under current tests is reliant on Class 2 NICs in respect of periods in the current tax year from April 2016 to December 2016. Since the SA Return will not be submitted until after the end of the tax year (from April 2017), under the general proposal Class 2 NICs would not have been paid for this period at the time of the MA claim.

4.7 Under the current system a similar scenario exists because Class 2 NICs is collected under both the billing system and direct debit in arrears. This may mean that Class 2 NICs is collected up to six months later than the period it is covering. Under the current system if a self-employed woman needs to rely on any Class 2 NICs not yet due for collection to claim MA, the woman contacts HMRC to pay the relevant Class 2 NICs before it is due.

4.8 The Government recognises that the proposals have implications for the way eligibility for MA is determined for pregnant self-employed women and will be considering how best to ensure the changes have no adverse impact for the small group who might otherwise be affected. This could include some exceptions processes for women who rely on either a SEE certificate or payment of Class 2 NICs in-year or involve a wider review of the current approach to testing eligibility to MA for self-employed women.

State Pension – Single Tier Pension

4.9 Under the current state pension system, Class 2 NICs count towards the basic state pension but not the additional state pension. A person needs 30 qualifying years to get a full basic state pension.

4.10 Under proposals to change the state pension from 2016, NICs paid by the self-employed will count towards the single-tier pension in the same way as those paid by employees. To receive the full weekly rate of the single-tier pension, an individual will need 35 qualifying years of NICs or credits.

4.11 NICs paid up to the end of the tax year before a person reaches state pension age count towards their state pension. The majority of people will have gained the full number of qualifying years, or the maximum number of qualifying years that they have been able to obtain, before they reach state pension age. However, the impact of collecting Class 2 NICs through SA may mean that some interim awards of state pension may need to be calculated pending payment of the final Class 2 NICs payment or HMRC will need to maintain an exceptions process to enable this minority group to pay Class 2 NICs in year.

Universal Credit (UC)

4.12 Universal Credit is a monthly household benefit. Around 650,000 self-employed households are expected to receive Universal Credit.

4.13 In order to calculate the level of a self-employed claimant's monthly Universal Credit award the DWP requires them to report their income on a simple, monthly 'cash in/cash out' basis.

4.14 The self-employed income reporting system is based on HMRC's recently introduced cash basis and simplified expenses (cash basis) accounting system. The DWP and HMRC have sought to align these systems as closely as possible to assist claimants who need to report their income to both departments, albeit for different purposes.

4.15 As the DWP requires a net income figure from the self-employed for Universal Credit purposes, when reporting their income, claimants are able to deduct (amongst other permitted items) payments of income tax, Class 2 and or Class 4 NICs made to HMRC from their monthly earnings.

4.16 One key principle of the cash basis is that 'cash in' is only recorded when received and 'cash out' recorded when payments are made.

4.17 SA payments can be made annually or spread over a number of months depending on when an individual files their SA return. The majority of individuals tend to file their return and pay their SA final payment in January. Therefore moving to collect Class 2 NICs through the SA return is likely to result in most people paying the entire Class 2 NICs liability in one month. This would result in the payment being reflected as one deduction for Universal Credit purposes in the month it is paid, rather than spread out as a monthly or six-monthly deduction as under the current system. The maximum Class 2 NICs an individual would pay as one deduction in a year is £140.49 (2013/14 rates).

4.18 In Universal Credit, a proportion of self-employed claimants will have a Minimum Income Floor[10] applied to their award. As Universal Credit is assessed on monthly earnings, a larger single annual deduction of Class 2 NICs could push a self-employed claimant's earnings below their Minimum Income Floor for that month, which would reduce their Universal Credit award for that month. This might not have been the case if they paid Class 2 NICs on a monthly basis. Under the proposal to collect Class 2 NICs through SA, this could be mitigated as individuals could still choose to spread their tax and NICs payments over several months if they filed their SA return soon after the end of the tax year.

[10] The Minimum Income Floor is an assumed level of earnings which is used to calculate some self-employed claimants' Universal Credit awards when they report actual earnings below the level of their Minimum Income Floor.

5. Scope for further Simplification

5.1 Chapter 3 sets out HMRC's core proposition for this consultation that Class 2 NICs could be collected through SA. In conducting this analysis HMRC has identified two possible further areas for simplification:

- Complete abolition of the Small Earnings Exception (SEE) process and removal of Class 2 liability from self-employed people with profits below the SEE limit;
- Alignment of the Class 2 and Class 4 rules.

5.2 HMRC would be interested in views on whether further simplification in the collection of self-employed NICs would be useful. The ideas discussed in this chapter are just two examples of possible areas HMRC could consider and respondents may also have other ideas to further simplify the current system.

Complete abolition of the SEE process

5.3 Around 60% of Class 2 payers with profits below the SEE limit are also employed and have earnings above the Lower Earnings Limit (£109 per week) (LEL). This may mean that they are already covered for contributory benefits through NICs paid on employment earnings and do not need to pay Class 2 NICs in order to protect their entitlement to contributory benefits. The main proposition of this consultation would still require individuals to make a decision as to whether to 'opt-out' of paying Class 2 NICs if they have low profits. There is potentially scope for further simplification by completely abolishing the SEE process and moving to a system where individuals only start paying Class 2 NICs once they have profits above the SEE limit (£5,725).

5.4 Removal of the Class 2 NICs liability from low profit self-employed people would align more closely with the treatment of low paid employees. Low paid employees are treated as having paid NICs if they have earnings from an employment at or above the LEL and start paying Class 1 NICs only once they have earnings from an employment above the primary threshold (£149 per week)[11]. Low paid employees who have earnings below £5,668 and who wish to

[11] £109 a week (annual equivalent £5,668)

maintain entitlement to State Pension and bereavement benefits can make voluntary Class 3 contributions. Class 3 NICs only give access to basic state pension and bereavement benefits.

5.5 There is the risk that some self-employed people would lose access to benefits currently afforded by payment of Class 2 NICs. Some people who have profits below the SEE limit may be entitled to a NI credit which would give the equivalent benefit rights as a Class 3 payment.

> **Q3.** Would complete abolition of the SEE process and removing liability to pay Class 2 NICs from people who have profits below the SEE limit be simpler than the current system? What benefits could this bring and do you see any drawbacks?

Aligning the Class 2 and Class 4 rules

5.6 Liability to pay Class 2 contributions has a broader scope than Class 4 contributions. Broadly speaking, Class 2 includes individuals conducting a business, trade, profession or vocation and was deliberately designed to be a wide definition. However liability to pay Class 4 is restricted to those who are conducting a trade, profession or vocation and are chargeable to tax under the trading income rules. Additionally the definitions as to what counts as "earnings" for Class 2 and "profits" for Class 4 NICs are different. A fuller technical description of the history is given in Annex B.

5.7 Neither the terms "business" nor "trade" in the definition of "employment" are defined in the Social Security Contributions and Benefits Act 1992. Therefore their meaning depends on the particular facts.

5.8 Case law has established that "business" is a wider term than trade and that the term "business" must be construed according to its context. The recent case of Ramsay v Revenue & Customs Commissioners [2013] UKUT 0226 (TCC) considered the case law on the meaning of "business" in the context of capital gains tax.

5.9 There is generally no dispute that activities amount to a trade but sometimes the issue is less self-evident. Statute provides little guidance on what amounts to trading. It is therefore usually necessary to refer to case law for guidance and there are a large number of cases dealing with the issue. The overall conclusion from case law can be characterised as:

- trade cannot be precisely defined, but;
- certain characteristics can be identified which are normally those of trade, and;
- other characteristics can be found which preclude a profit from being that of a trade.

5.10 The difference between 'running a business' and 'trading' is not clear cut and we expect that this is a complex area for customers to self-determine which classes of contributions they are liable to pay and what counts as earnings for Class 2 and profits for Class 4 contributions. Examples of those with a liability to pay Class 2 NICs but not Class 4 NICs include individuals operating property or investment businesses who are taxed under the property or investment rules rather than the trading income rules. Some of these people may not consider themselves to be self-employed but consider themselves instead to be investors.

5.11 One consequence of basing the liability to pay Class 2 contributions on the Class 4 rules would be that some property or investment businesses that are not trading may no longer be liable to pay Class 2 NICs. Special rules would be needed to accommodate the small number of people living in other EU Member States who are self-employed in the UK and paying Class 2 but who are not resident here for income tax purposes.

5.12 HMRC recognises that Class 4 is only payable if an individual has profits over the lower profits limit (£7,755 per year) while Class 2 is payable on any level of profit or loss (subject to the small earnings exception). This section only seeks views on whether the underling rules should be aligned. Reformed Class 2 would remain (subject to the small earnings exception) payable for those with low or no profits.

5.13 The Government would be interested to seek the views of respondents about this and whether individuals engaged in such businesses who meet the Class 2 definition of a business but not the Class 4 definition might be reliant on Class 2 NICs for access to contributory benefits.

5.14 The examples discussed above give an indication of the types of further change HMRC could consider to simplify the current system. HMRC is interested in whether these examples might deliver simplification and also in other ideas respondents may have.

Questions

Q4) Would aligning the liability to pay Class 2 with the liability to pay Class 4 NICs be a simpler system for the majority of self-employed individuals? What benefits could this bring? Do you see any drawbacks?

Q5) What groups might be excluded from paying Class 2 NICs if liability to pay Class 2 NICs aligned with the current Class 4 rules?

Q6) Do you have other ideas that might deliver further simplification for the collection of NICs from the self-employed?

Q7) Are there any direct or indirect equality impacts from any of the changes discussed in this document?

6. Assessment of Impacts

Summary of Impacts of Collecting Class 2 NICs through the SA system

Exchequer impact (£m)	2011-12	2012-13	2013-14	2014-15	2015-16
	+/-	+/-	+/-	+/-	+/-
Economic impact	Making the process simpler for small businesses.				
Impact on individuals and households	At an individual level this change should make the administration of NICs easier because individuals will only have to deal with one process rather than two separate processes. Collecting Class 2 through SA could result in the payment of NICs being reflected as one deduction for Universal Credit purposes in the month it is paid, rather than spread out as a monthly or six-monthly deduction as under the current system (see pages 24-25). Individuals will have the opportunity of spreading their payments if they file soon after the end of the tax year.				
Equalities impacts	This change will affect self-employed people and therefore will affect any groups with protected characteristics[12] that are over-represented within the self-employed population. As referred to at paragraphs 4.6-4.8 this change may have a direct impact on some self-employed pregnant women and HMRC expects to put in place an exceptions process to address this.				
Impact on businesses and Civil Society Organisations	Collecting Class 2 NICs through SA may reduce the administrative burden on small businesses.				

[12] The nine protected characteristics are age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion and belief, sex and sexual orientation.

Impact on HMRC or other public sector delivery organisations	HMRC will incur costs to make changes to I.T. systems to collect Class 2 NICs through SA. There will be some annual administrative savings to HMRC once the new collection process is implemented. These costs will be established as any new process is developed.
Other impacts	Other impacts have been considered and none have been identified.

Q8. Do you have any comments or suggestions on the indicative impacts identified in the table of impacts?

7. Summary of Consultation Questions

Q1a) Overall would collecting Class 2 NICs through the Self Assessment system be simpler?

Q1b) What benefits do you think this could bring to customers?

Q1c) Do you see any drawbacks?

Q2) What do you consider will be the transitional challenges of moving from the current system to collecting Class 2 NICs through the SA system?

Q3) Would complete abolition of the SEE process and removing liability to pay Class 2 NICs from people who have profits below the SEE limit be simpler than the current system? What benefits could this bring and do you see any drawbacks?

Q4) Would aligning the liability to pay Class 2 with the liability to pay Class 4 NICs be a simpler system for the majority of self-employed individuals? What benefits could this bring and do you see any drawbacks?

Q5) What groups might be excluded from paying Class 2 NICs if liability to pay Class 2 NICs aligned with the current Class 4 rules?

Q6) Do you have other ideas that might deliver further simplification for the collection of NICs from the self-employed?

Q7) Are there any direct or indirect equality impacts from any of the changes discussed in this document?

Q8. Do you have any comments or suggestions on the indicative impacts identified in the table of impacts?

7. The Consultation Process

7.1. This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

Stage 1	Setting out objectives and identifying options.
Stage 2	Determining the best option and developing a framework for implementation including detailed policy design.
Stage 3	Drafting legislation to effect the proposed change.
Stage 4	Implementing and monitoring the change.
Stage 5	Reviewing and evaluating the change.

7.2. This consultation is taking place during stage 1 of the process. The purpose of the consultation is to seek views on the policy design and any suitable possible alternatives, before consulting later on a specific proposal for reform.

7.3. Ministers will give an update of the progress of this work at Autumn Statement. After considering the views of respondents, should Ministers decide to proceed an indicative timetable for this change is outlined in the table below:

Date	Activity
Summer 2013	Stage 1 consultation to test whether the options would deliver genuine simplification and to understand fully the impacts of any change.
Autumn 2013	Publication of consultation responses. Subject to the outcome of the consultation, reforms decided and announced. Further consultation if required.
2014-15	Legislation drafted, consulted upon and then, subject to parliamentary time being available, taken through Parliament I.T. system design, development and deployment.
April 2016	Reforms come into effect

How to respond

A summary of the questions in this consultation is included at chapter 7.

Responses should be sent by 9th October 2013, by e-mail to consultation.nic@hmrc.gsi.gov.uk or by post to:

Samantha Tennakoon
HM Revenue & Customs
100 Parliament Street
Room 1E/17, 100 Parliament Street
London
SW1A 2BQ

Telephone enquiries 0207 147 0582 (from a text phone prefix this number with 18001)

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from HMRC Inside Government. All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentially can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles. [If you wish to explain your choice of consultation period, this is the place. Also, if you are holding additional meetings or using alternative means of engaging, please mention this here].

The Consultation Principles are available on the Cabinet Office website: http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance

If you have any comments or complaints about the consultation process please contact:

Amy Burgess, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex A: The Current System

Background to the National Insurance Scheme

1. The National Insurance Scheme, first introduced in 1911 but assuming its present design in 1975, is the compulsory insurance of a gainfully employed person, whether as an employed earner (an employee) or a self-employed earner, in order to provide the earner with replacement income during periods of sickness, pregnancy, unemployment or old age.

2. The Scheme also allows those who are not gainfully employed and therefore not compulsory insured to pay contributions on a voluntary basis to protect entitlements.

3. Although the Scheme has been expanded and developed over the succeeding decades, it remains underpinned by the contributory principle. In short, this provides that those who contribute to the Scheme while in work are entitled to receive financial support when they are not able to work.

4. For individuals, the National Insurance contributions they pay need to be recorded over their whole working life, as they are used by the Department for Work and Pensions (DWP) to calculate contributory benefit entitlements. In some cases, such as the UK's state pension system, entitlement is based on the amount of contributions paid by a person over their whole working life. For this reason, each individual's National Insurance payments are separately recorded on his or her personal National Insurance records.

Employed or self-employed

5. The difference between being employed and being self-employed is as important for National Insurance contribution purposes as it is for other areas of the law, such as income tax, VAT and employment rights. This is because the distinction will not only govern the amount of contributions that a person is required to pay and when they are required to pay them but it will also govern what contributory benefits they are able to claim.

6. At the moment, for contribution purposes an employed earner is a person who is gainfully employed in the United Kingdom under a contract of service, or a person who holds an office with earnings that are taxed as general earnings. A self-employed person is any other person who is gainfully employed. This catch all definition for the self-employed provides that anybody who is gainfully employed is required to pay contributions under the National Insurance scheme.

What does ordinarily self-employed mean?

7. A person is regarded as ordinarily self-employed for contribution purposes unless and until they are no longer self-employed. This means that, with the exceptions covered in paragraph 16, a self-employed person is treated as being ordinarily self-employed during temporary breaks in their work, for example holiday periods, short periods spent abroad or temporary periods without work.

8. A person who is self-employed even for a few hours each week is required to pay contributions as a self-employed person, whether this is the sole source of their employment, or is undertaken in addition to any work as an employee. In some instances, the level of activity in which the person is engaged will be insufficient to regard the person as self-employed. An example would be a keen vegetable grower on an allotment who might occasionally sell some excess produce.

Employed and self-employed

9. A person can be both employed and self-employed at the same time. The decision about which category of employment a person falls into is made on a job by job basis and in some cases an individual can be required to pay both contributions as an employee and as a self-employed person.

10. Those that hold more than one employment at the same time are provided with a maximum contribution liability. This maximum provides that a person with two or more jobs will pay broadly the same amount of contributions as a person with one job receiving the same level of earnings (see paragraphs 51-54 for more details).

Registering as a self-employed person with HMRC

11. Self-employed individuals are required to register with HMRC to pay Class 2 contributions, either when they register for Self Assessment or by contacting HMRC directly. A penalty is payable by those who do not register as self-employed with HMRC. The need to register applies irrespective of the level of earnings that a person anticipates making.

Class 2 contributions

1. **12.** All individuals who are aged 16 or over and who are ordinarily self-employed are required to pay a flat rate Class 2 contribution in respect of each contribution week in a tax year in which they carry on activities as a self-employed earner. This liability continues until the person:

- reaches state pension age;
- stops being ordinarily self-employed;

- or, is otherwise exempt from Class 2 contributions[13].

13. A contribution week runs from midnight on Sunday to midnight on the following Saturday. There are normally 52 contributions weeks in a tax year but in some years the number can rise to 53.

How are Class 2 contributions assessed?

14. Class 2 contributions are a flat rate contribution, and are payable regardless of the level of a self-employed person's earnings (see paragraph 23-27 about those who have low earnings from self-employment). The value of Class 2 contributions is reviewed annually and is normally adjusted by the rate of inflation.

15. For the tax year 2013/14 the weekly rate of Class 2 contributions is £2.70 and there are 52 contribution weeks in this tax year. The total amount of Class 2 contributions due from someone who has been self-employed for the whole of the 2013/14 tax year is £140.40.

> Example
>
> Joe became a self-employed earner on the 1st July 2013. Providing Joe remains ordinarily self-employed throughout the remainder of the 2013/14 tax year, he will be required to pay 40 Class 2 contributions at a cost of £108 (40 contribution weeks from 1st July 2013 to 5th April 2014 x £2.70)

When are Class 2 contributions not payable?

16. There are various times during which a person who is ordinarily self-employed is not required to pay Class 2 contributions. Payment is not required where a person:

- anticipates that their earnings from self employment will fall below a set threshold and makes an application to be excepted from payment (see paragraphs 23-27);
- is below the age of 16 or at or above state pension age;
- is in receipt of Incapacity Benefit/Employment and Support Allowance or is otherwise incapable of work;
- is in receipt of Maternity Allowance;

[13] Section 11 of Social Security Contributions and Benefits Act 1992, together with regulation 3 of the Social Security (Categorisation of Earners Regulations) 1978 (SI 1978/1689)

- is undergoing imprisonment or detention in legal custody;
- is in receipt of carer's allowance or an unemployability supplement.

Example Joan has been self-employed for five years. During the tax year 2013/14 she received Maternity Allowance for 26 weeks before returning to her self-employment. Providing Joan remains ordinarily self-employed throughout the remainder of the 2013/14 tax year, she will be required to pay 26 Class 2 contributions at a cost of £70.20 (52 contribution weeks in the year less 26 weeks Maternity Allowance x £2.70)

How are Class 2 contributions paid?

17. Class 2 contributions can be paid in one of two ways – either by direct debit through a nominated bank account or as the result of HMRC issuing a payment request. A self-employed person can choose which method to use and can change their preferred method of payment to an alternative at any point in the tax year.

a) Paying by direct debit - there are two options:

- monthly direct debit payments collected four month in arrears – each month's Class 2 contributions are collected four months in arrears from the person's nominated bank account. For example, the payment for the period 7 April 2013 to 11 May 2013 would be collected on 9 August 2013
- six monthly direct debit – twice a year, in January and July – Class 2 contributions are collected in arrears from the person's nominated bank account.

b) Paying by six monthly payment request:

- Under the six monthly payment request method HMRC issues two payment requests each year. Payment can then by made by either online or telephone banking, by post or at a bank/post office.

What happens if Class 2 contributions are not paid by the due date?

18. Late paid Class 2 contributions are not subject to interest or a separate financial penalty. Instead Class 2 contributions which are not paid by the due date are subject to two types of sanction.

19. First, Class 2 contributions which are not paid by the end of the tax year following the tax year in which they were due to be paid, are charged at the highest weekly rate of Class 2 contributions in force between the date when payment should have been paid and the date when payment is made.

> Example
>
> Keith has been self-employed since July 2011 but has not paid any Class 2 contributions. It is now June 2013. The rate of Class 2 contributions for the tax year 2011/12 was £2.50 and for the 2013/14 tax year it is £2.70. As Keith has not paid his Class 2 contributions for the tax year 2011/12, they are now due at the Class 2 rate in force for the tax year 2013/14.

20. Second, Class 2 contributions which are not paid within six tax years following the tax year in which they due are ignored when assessing a self-employed person's entitlement to claim contributory benefits.

21. If Class 2 contributions are paid within the six year period but after the end of the relevant benefit year[14] there is a further sanction. Contributions paid after the start of the relevant benefit year are not treated as paid until 42 days later. In practice this means that a claim to a short term contributory benefit such as Employment and Support Allowance could be disallowed for up to six weeks.

22. If Class 2 contributions are not paid before the beginning of a claimant's Maternity Allowance Period (MAP), a claimant may lose entitlement from the MAP start date to the day before the contributions are paid.

> Example 1
>
> Kathy has been self employed since 4 March 2010 and was paying Class 2 NICs by direct debit. When she changed her bank account in May 2012 she failed to notify HMRC and as a result her Class 2 contributions have not been paid. On 23 May 2013 Kathy claimed MA but was not entitled because the earnings test was not satisfied. On 16th July 2013, Kathy pays the outstanding arrears and notifies DWP that she has made a payment of class 2 contributions. HMRC confirm that the contributions were allocated for 2011/12 tax year. DWP revise the prior decision to allow MA from 16 July 2013 as the payments are treated as being paid on time and within the relevant period.

[14] The benefit year runs from the first Sunday in the calendar year to the last Saturday before the first Sunday in the following calendar year. The 2013/14 benefit year runs from 6 January 2013 to 4 January 2014. For 2013 benefit year for ESA the relevant tax years are 2010/11 and 2011/12.

Example 2 Joan has been self employed since 12 October 2009, but has failed to pay Class 2 contributions since July 2010. On 17th April 2013 Joan claimed Maternity Allowance but was not entitled because the earnings test was not satisfied. On 20 September, Joan makes a payment of class 2 contributions. HMRC confirm that the contributions were allocated to 2010/11 tax year and this falls outside of the relevant test period for MA. Accordingly MA is not payable.

Low earnings from self-employment

23. Although every self-employed person is required to pay Class 2 contributions, anyone who anticipates that their earnings from self-employment will fall below an annual threshold can apply for exception from Class 2 contributions. The threshold is referred to as the Small Earnings Exception (SEE) and is set annually. For the tax year 2013/14 the SEE limit has been set at £5,725.

24. Exception from Class 2 contributions under the SEE process is not granted automatically. A self-employed person must make an application to HMRC. If the application is granted a certificate of Small Earnings Exception is issued to the person. Such certificates can be backdated but only to the start of the tax year or a maximum of 13 weeks from the application date, whichever is the shorter.

25. Where Class 2 contributions have not been paid but a SEE would have been available had an application been made within the time limit of 13 weeks, HMRC may decide not to collect the outstanding amounts of Class 2 NICs.

26. Where Class 2 contributions have been paid but a SEE would have been available had an application been made within the time limit of 13 weeks, a repayment of the overpaid contributions can be made, subject to the satisfaction of certain conditions. The conditions are that the application:

- must be in writing;
- must be supported by evidence of low earnings for the tax year in respect of which a repayment is being sought; and
- must be made not earlier than 6th April and not later than 31January immediately following the end of the tax year in question.

27. Where an application is made on time and HMRC confirms that an exception from Class 2 contributions under the SEE scheme would have been available to the person had an application been made, a retrospective exception will be granted and any Class 2 contributions will be repaid. Any contributory benefit that had been paid on the basis of the contributions to be refunded is deducted from the amount of the refund.

Earnings for the purposes of Small Earnings Exception

28. The expression 'earnings' for National Insurance purposes includes "any remuneration or profit derived from an employment" and "employment" is defined as any trade, business, profession, office or vocation. The term earnings therefore applies to the income of both an employed earner (an employee) and a self-employed earner.

29. Although the requirement to pay Class 2 contributions is not based on the level of a self-employed person's earnings, or their taxable profits which can provide for a different figure, the level of earnings becomes an important consideration for those who wish to claim exception under the SEE.

30. The earnings for a tax year are used to determine whether a self-employed person is entitled to claim exception on the ground of low earnings. They are also the net earnings from self-employment, which means the figure that would normally appear in a profit and loss account prepared in accordance with normal accounting principles. This means that deductions from gross earnings for items that are incurred in running a business can be deducted, as well as deductions for depreciation, although no deduction can be made for payments of Class 2 or 4 contributions.

31. Other items that can be deducted from the earnings of a self-employed person include:

- earnings from any employed earners employment, even if those earnings are shown as a receipt of the business;
- payments of an employment credit or training grant given to a self-employed earner as a participant in any scheme arranged under section 2(2) of the Employment and Training Act 1973 and referred to as "New Deal 50 plus;"
- payments made to a self-employed person under schemes mentioned in section 60(1) of the Welfare Reform Act.

32. Although a self-employed person's net earnings relevant to a particular tax year are the person's actual earnings for that year, HMRC will accept as the figure of earnings that which is shown in the person's self-employed accounts, even if the accounts cover a different period.

33. If, however time apportioning the accounts will provide a figure of earnings below the SEE limit, a self-employed person is entitled to request that this method be used to assist an application for SEE.

Maurice is a self-employed window cleaner and his business has started slowly. His accounting year ends on the 30 August and his accounts show the following earnings:

Year ending 2011/12	loss = £2,000
Year ending 2012/13	profit = £7,000

For the purposes of Maurice's SEE application for 13/14 (which needs to reflect earnings below the SEE limit of £5725), Maurice is entitled to calculate his earnings for the 2013/14 tax year as:

5/12 x £(2000) =	£(833.33)
7/12 x £7000 =	£4083.33
	£3250.00

Maurice would be entitled to claim SEE for the tax year 2013/14

Payment of Class 2 contributions on a voluntary basis

34. In certain circumstances Class 2 contributions can be paid on a voluntary basis. Payment of voluntary contributions can be made by:

- Direct debit
- Payment requests sent by HMRC twice yearly
- Annually

35. A self-employed person who is excepted from Class 2 contributions for any of the reasons outlined at paragraph 16 remains entitled to pay a Class 2 contribution for any week in which they are excepted if they wish to do so, except in the case of certain married women who are excepted from liability to pay Class 2 NICs by reason of a reduced rate election.

36. Equally, although a certificate of SEE excepts the holder from liability to pay Class 2 contributions for any contribution week during the whole of which it is in force, the person is entitled to pay Class 2 contributions on a voluntary basis.

Self-employed and employed

37. Where a person is both employed and self-employed at the same time, a liability to pay contributions as both an employee and a self-employed person arises. The potential to pay contributions in multiple employments is restricted by an annual maximum of contribution liability. More details about how the annual maximum works for those with multiple employments is provided at paragraphs 51-54.

38. Anyone who is both self-employed and employed and who anticipates they will pay sufficient NICs on other earnings up to the maximum has the choice of deferring their Class 2 NICs and some of their Class 4 NICs until the end of the tax year. At this point HMRC will carry out an annual reconciliation to check the actual amount of contributions paid and due. For those who have applied to defer some of their liability, HMRC will either acknowledge that the customer has paid sufficient NICs or ask for additional payment. Those who have not applied for a deferment but who have paid their Class 2 NICs during the year will be invited to apply for a refund.

Class 4 NICs

39. As well as paying Class 2 contributions, most self-employed people who are required to pay Class 2 contributions are also required to pay Class 4 contributions.

Class 4 contributions are paid by those whose profits are:

- immediately derived from the carrying on of a trade profession or vocation;
- are chargeable to income tax under Chapter 2 of Part 2 of the Income Tax (Trading and Other Income) Act 2005, (formerly Case I and II of Schedule D of the Income and Corporation Taxes Act 1988) and;
- are not profits of a trade, profession or vocation carried on wholly outside the United Kingdom.

40. Class 4 contributions do not give the payer any entitlement to contributory benefit. Instead, they were introduced in order that the self-employed could pay a fairer share of the costs associated with providing contributory benefits.

41. Although it is Class 2 contributions that give the self-employed entitlement to contributory benefits, Class 4 contributions are paid into the National Insurance Fund and a proportion is paid over to the National Health Service.

How are Class 4 contributions assessed?

42. Class 4 NICs are calculated as a percentage of the tax payers taxable profits falling between a lower and an upper profit limit, in a year of assessment. The year of assessment is the income tax year for which tax under ITTOIA is payable.

43. The Class 4 percentage and both the lower and upper Class 4 limits are reviewed each year.

44. The amount of tax and Class 4 NICs payable is normally based on the profits or gains for the accounting year which ended in the income tax year. The accounting year is normally the period of 12 months covered by a contributor's accounts. It can start on any day.

45. Class 4 contributions are paid in respect of a person's annual profits and payable for the year, irrespective of whether the person commenced or ceased their self-employment part way through a tax year.

For the tax year 2013/14 the rates and thresholds applicable to Class 4 NICs are:

Lower Profits Limit (LPL)	£7755
Upper Profits Limit (UPL)	£41450
Class 4 percentage payable on profits between LPL and UPL	9%
Class 4 percentage payable on profits above the UPL	2%

Example

Nigel has been self-employed for twenty years. In respect of the 2013/14 tax year his profits from his business were £45,000

Nigel is required to pay the following Class 2 and 4 contributions for the 2013/14 tax year

Class 2	52 weeks x £2.70	= £140.40
Class 4	45,000 – 41,450 = 3550 x 2%	= £71.00
	41,450 - £7755 = 33695 x 9%	= £3032.55
		= £3243.95

When are Class 4 contributions not payable?

46. There are various reasons why Class 4 contributions may not be payable during times where a person is ordinarily self-employed and required to pay Class 2 contributions or during times where neither Class 2 nor Class 4 are payable but income tax is payable.

Payment of Class 4 is not required where a person:

- does not derive their profits immediately from a trade, profession or vocation (for example receives investment income);
- has taxable profits below the Class 4 lower profits threshold;
- is, at the beginning of a tax year, at or over state pension age;
- is, at the beginning of the tax year, under the age of 16;
- is non resident for tax purposes;
- is a trustee, guardian, tutor, curator, or committee of an incapacitated person who would otherwise be assessable and liable to Class 4 contributions;
- any other form of trustee;
- certain divers and diving supervisors;
- others who are chargeable to tax on business profits but who are treated as employed earners for contribution purposes.

Class 4 profits

47. Although Class 4 NICs are effectively paid by those who are categorised as self-employed for contribution purposes, the payment of Class 4 is not dependant upon the person also being liable to pay Class 2. Instead, Class 4 contributions are payable in respect of profits that are immediately derived from the carrying on of a trade, profession or vocation, if those profits are chargeable to tax as trading profits.

48. The profits which are immediately derived from the carrying on a trade etc for tax are subject to various adjustments before they become chargeable to Class 4 NICs. In some instances tax but neither Class 2 or 4 contributions will be payable and in other cases tax and Class 4 contributions will be payable on certain payments whilst the same payments can be ignored for the purposes of calculating earnings for the Class 2 SEE.

Special Class 4 contributions

49. Special Class 4 contributions are payable by an earner who is treated as a self-employed earner by regulations. Special Class 4 Contributions are calculated by reference to the same percentages and thresholds as ordinary Class 4 contributions but they are payable on what would otherwise be the earners Class 1 earnings.

50. At present special Class 4 contributions are payable by some examiners and some share fishermen.

The annual Class 1, 2 and 4 maxima for those who are both employed and self-employed

51. Legislation contained within the Social Security Contributions and Benefits Act (SSCBA) 1992 sets out the conditions under which a liability for NICs arises. The law imposes a full liability in respect of each employment held by an individual. The effect of this is that without some form of limit, a person who holds more than one employment, or who is both employed and self-employed, would face a NICs liability on all of their earnings and/or profits above the relevant thresholds from each employment held. This means that such earners could pay far more NICs than is necessary to secure full benefit entitlement and far more than a person who earns the same amount but from a single employment.

52. From 6 April 2003 changes to the structure of Class 1 and Class 4 NICs included the introduction, for the first time, of an uncapped Class 1 and Class 4 NICs liability on earnings above the Upper Earnings Limit and profits in excess of the Upper Profits Limit. The introduction of this additional liability, whilst uncapped, does nothing to limit the amount a person pays in cases where a contributor holds more than one employment. This means that such contributors would, without the retention of a Class 1, 2 or Class 4 NICs maximum, be required to pay Class 4 NICs on all of their profits above the Lower Profits Limit whilst, at the same time, paying Class 1 NICs on all of their earnings above the Primary Threshold.

53. For this reason there remains an annual Class 1, 2 and Class 4 NICs maximum for tax years 2003/2004 onwards. Retention of a Class 4 NICs annual maximum means that a contributor who is both employed and self-employed is required to pay, broadly, the same amount of NICs as a person who has equivalent earnings but solely from being an employee.

54. Although the principle of an annual maximum is retained, the uncapped Class 4 NICs liability on profits above the Upper Earnings Limit means that there can no longer be a universal maximum figure applying to all contributors. Instead all contributors who are both employed and self-employed are provided with an individualised maximum. This individualised maximum is determined by reference to individual profits and the amount of Class 1 and 2 NICs paid.

Annex B: Technical Background to the Class 2 and Class 4 definitions

1. Section 2(1)(b) of the Social Security Contributions and Benefits Act 1992 (and its Northern Ireland equivalent) define those that are liable to pay Class 2 NICs: -

> (b) "self-employed earner" means a person who is gainfully employed in Great Britain otherwise than in employed earner's employment (whether or not he is also employed in such employment).

"employment" is defined in section 122(1) as: -

> "employment" includes any trade, business, profession, office or vocation and "employed" has a corresponding meaning;"

2. The definition of "self-employed earner" is little changed from that of the definition of "self-employed persons" that appeared in the National Insurance Act 1946. It was deliberately designed to be a sweeping definition at that time because the definition of "employed persons" (for liability to pay Class 1 contributions) was restricted to only those engaged under a contract of service. The definition of "self-employed persons" was designed not only to include those that most people would ordinarily regard as self-employed but also office holders and others liable to income tax under Schedule E but not engaged under contract of service.

3. The definition of "employment" also derives from the National Insurance Act 1946 but it was itself adapted from the definition of "gainfully occupied person" in section 8 of Personal Injuries (Emergency Provisions) Act 1939: -

> "gainfully occupied person" means a person who is engaged in any trade, business, profession, office, employment or vocation and is wholly or substantially dependent thereon for a livelihood, or a person who, though temporarily unemployed, is normally so engaged and dependent;"

4. This Act sets out the framework for a scheme for paying compensation to gainfully occupied persons who sustained war injuries during World War II. The original policy intention was to encourage people to carry on working during war time and it was the intention to exclude the non-gainfully occupied from compensation if injured. Broadly, non-gainfully occupied persons were those whose income was independent of their well being or capacity to work.

5. The Social Security Act 1973 introduced the current definition of "employed earner" and the definition was widened to include not only those engaged under a contract of service but also office holders and others liable to income tax under Schedule E but not engaged under contract of service. However, the definition of "self-employed earner" was not changed from that contained in the National Insurance Act 1946 but the widening of the scope of the definition of "employed earner" meant that office holders and others liable to income tax under Schedule E but not engaged under contract of service were no longer in the category of "self-employed earner".

6. The Government of the day in 1973 described the effect of these changes as follows: -

> "In line with the Government's broad intention of bringing the social security and income tax arrangements closer together the main aim is to ensure that people taxed under Schedule E pay Class 1 contributions and those taxed under Cases I and II of Schedule D pay Class 2 and 4 contributions, thereby greatly simplifying the collection arrangements."

7. Class 4 contributions were introduced by the Social Security Act 1973 and unlike Class 2 NICs, liability to pay such contributions do not depend on a definition of self-employment but rather they are payable in respect of profits 'immediately derived' from the carrying on or exercise of one or more trades, professions or vocations, being profits or gains chargeable to income tax under a trade, profession or vocation ITTOIA 2005, Part 2, Chapter 2 for any tax year of assessment. This is presently defined in section 15(1) of the Social Security Contributions and Benefits Act 1992: -

> (1) Class 4 contributions shall be payable for any tax year in respect of all [profits] which—
>
> (a) are immediately derived from the carrying on or exercise of one or more trades, professions or vocations,
>
> (b) are profits chargeable to income tax under Chapter 2 of Part 2 of the Income Tax (Trading and Other Income) Act 2005] for the year of assessment corresponding to that tax year [and
>
> (c) are not profits of a trade, profession or vocation carried on wholly outside the United Kingdom.

8. As well as the liability structure of Class 2 and 4 contributions being different they are also administered differently with regard, for example, to refunds and appeals. Whereas the provisions in the Taxes Management Act 1970 apply to Class 4 contributions, separate provisions in the Social Security Contributions and Benefits Act 1992 and the Social Security (Contributions) Regulations 2001 apply to Class 2 contributions.