



NATIONAL INSURANCE CONTRIBUTIONS FOR THE SELF-EMPLOYED: ABOLITION OF CLASS 2 AND MAKING CLASS 4 CONTRIBUTORY

ICAEW welcomes the opportunity to comment on the consultation [*The abolition of Class 2 National Insurance: Introducing a benefit test into Class 4 National Insurance for the self-employed*](#) published by the Department of Work and Pensions, HM Revenue & Customs and HM Treasury on 9 December 2015.

This response of 24 February 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

We responded in February 2015 in TAXREP 20/15 to HMRC's consultation on the payment of Class 2 national insurance contributions, in October 2013 in TAXREP 54/13 to HMRC's July 2013 consultation document *Simplifying national insurance processes for the self-employed* and in June 2008 in TAXREP 37/08 to HMRC's March 2008 consultation document. Over the years, we have met HMRC (and predecessors) on many occasions to discuss NIC simplifications and how they might work in practice.

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MAJOR POINTS

Key point summary

1. We support in broad terms the idea of combining the social security liabilities of self-employed workers into a single type of contribution, together with aligning the bands of earnings on which liabilities arise. Given the trivial difference that will exist from 6 April 2016 between the contributory benefit entitlements of employed and self-employed contributors, it clearly makes sense for the basis of the self-employed contribution calculation, and the process of converting it into benefit entitlements, to be as similar as reasonably possible to the basis and process for employed earners. Ministers should, however, be prepared to explain to the employee population why they will pay 12% of 'band' earnings (using the SERPS term for ease of reference) while the self-employed will pay only 9% of the same band. Class 2 has to date justified that differential, in broad brush terms, but abolition would highlight the discrepancy. The absence of any equivalent to employer contributions for the self-employed themselves (ie, not in their role as employers), despite their state benefits being aligned in future with those of their employed co-workers, might also be a matter requiring explanation.
2. That said, we consider that the proposals need rethinking. They do not meet the government's stated objectives that (in a nutshell) a reformed self-employed NIC should be simpler, and contributory benefits should be accessible equitably to all self-employed individuals. While the proposal to abolish Class 2 and levy Class 4 annually, with a nil rate band that attracts benefit entitlements, is superficially attractive in terms of ease of collection (although we question whether it will be any easier than the 2015-16 model of two six-monthly payments through the ITSA system, or the forthcoming quarterly payment regime), the proposals would make the link to benefits much more complex, especially for those who also have employment income within the scope of Class 1 NICs in the same tax year, be that from concurrent or consecutive activities. Moving self-employed NICs onto an annual basis while Class 1 and Class 3 still work on a weekly or monthly basis would not result in simplification, and would not make the system easier to understand for taxpayers and contributors. Class 1 and Class 2 work on the basis of qualifying weeks, with Class 3 weekly contributions used to plug gaps in the record of qualifying weeks. Furthermore, redefining the value of Class 3 contributions so that they may be used instead of Class 2 in certain circumstances seems a very retrograde and anti-simplification idea.
3. With a view to arriving at a system that is logical, easy to administer and easy for the contributing public to understand, we recommend:
 - Merging Class 4 into Class 2 and keeping the name Class 2. The self-employed understand that Class 2 has a contributory nature, and might more readily understand a reformulation of Class 2 liability accompanied by the abolition of the apparently much bigger burden of Class 4.
 - Setting the formula for calculating the new single charge based on the current structure of NIC rates. We envisage:
 - a flat rate of around the current Class 2 amount per week on profits while self-employed between small profits threshold (SPT, aligned with the Class 1 LEL) and a lower profits limit (LPL, aligned with the Class 1 primary threshold), or
 - the higher of that flat rate and a fixed percentage of profits between LPL and upper profits limit, with those with profits below the SPT, or losses, or in business without trading (eg, certain landlords), able voluntarily to pay NIC at the same flat rate to protect or preserve benefit entitlements.
 - In order to facilitate the combination of Classes 1, 2 and 3 contributions to create a qualifying record for benefits, retaining a weekly basis to assess liability to NIC and eligibility to contributory benefits.

- Retaining the current rules for special groups, such as share fishermen (eg, setting a higher flat rate base), volunteer development workers (who pay voluntary contributions based on Class 1 thresholds anyway), examiners, non-stipendiary ministers of religion, and expatriates (although we could see a justification for asking the last of these to pay Class 3 rates to protect entitlements for periods of absence abroad, rather than the trivial current Class 2 rate).

General comments

Our recommendations

4. We welcome the fact that the government has not set a date for reforming self-employed national insurance contributions (NIC) and we agree that the government's objectives for reform summarised in the Introduction to the consultation document are appropriate.
5. The proposals envisage that the contributions structure of the merged self-employed NIC would be broadly similar to employees' primary Class 1 but with an annual rather than weekly profits periods for NIC and entitlement to benefits. Contributory benefit rules would be changed to fit in with an annual profits basis.
6. We consider that the proposals in the consultation need rethinking for many reasons which we explain below
7. It is unclear why it is necessary to change and complicate the benefits legislation when the aim of the reform is simplification of the contributions regime.
8. We also question whether the proposed changes to the NIC and entitlement to benefits rules would complicate the interface between the UK social security system and those of other countries in the context of international social security agreements. For example, the UK-US social security treaty includes totalisation provisions that refer explicitly to 52 or 50 Class 2 contributions as a component of relevant earnings factors, and other treaties (such as UK-Turkey) refer to contribution weeks.
9. We consider that the outcome which best meets the government's objectives for reform would be a regime broadly based on what we have now for those in business, so that:
 - the self-employed with trading profits between the small profits threshold (SPT, but aligned with the Class 1 LEL as proposed) and lower profits limit (LPL, aligned with the Class 1 primary threshold, as now) would pay NIC at a flat rate, more or less equal to the current Class 2 rate, to ease the transition, and
 - the self-employed with trading profits over the LPL would pay NIC amounting to the greater of the flat rate and a percentage of profits (trading profits computed using the same ITTOIA-based rules as now). We assume that government does not propose to abolish the upper profits limit and additional rate, so as to maintain alignment with Class 1 at the upper end, but as the document is silent we would welcome confirmation.
10. In the interests of fairness, individuals in business should be able voluntarily to pay self-employed NIC at the same flat rate, so traders with profits below the SPT, or losses, and other business people, for example landlords letting property as a business, should be able to accrue the same state pension and contributory benefit entitlements on the same basis as those compulsorily paying the flat rate of self-employed NIC.
11. Further, although, as at present, payment would be annual via the self-assessment, subject to an exceptions process for expectant mothers intending to claim maternity allowance, the contribution period should remain weekly, so that the NIC thresholds for those who are in business for only part of a year would be based on the appropriate number of weeks. This

would mean that the merged self-employed NIC regime would in this respect align with Classes 1 and 3, and facilitate NIC credits (eg, for weeks of jury service or incapacity), and cross-border social security coordination.

12. Our foregoing recommendations would obviate the need to rewrite the rules governing entitlement to contributory benefits and renegotiate certain social security agreements (and the related systems in Newcastle), and we believe would better meet all the government's objectives outlined in the document (simplification, access to contributory benefits on an equal basis, etc) and our *Ten Tenets for a Better Tax System* (outlined in Appendix 1) than the proposals in the document.
13. As the merged NIC for the self-employed will be contributory, we also recommend retaining the nomenclature Class 2 rather than Class 4, as this will help reinforce the message to contributors that the reformed self-employed NIC earns them state pension and state benefit rights (whereas naming the merged self-employed NIC Class 4 will reinforce the view that self-employed NIC is another tax).

Our concerns and queries about the proposals

14. We believe that most self-employed people think that it is unnecessarily complicated to have to pay two classes of NIC. We therefore support moving to one class of self-employed NIC but only if the outcome is simple, or at least simpler than at present. However, we suggest that the proposal to merge Class 2 into Class 4 is the wrong way round and that, instead, consideration should be given to merging Class 4 into Class 2.
15. First, albeit somewhat trivially, if Class 2 is abolished, there will be an apparently illogical gap in the NIC class numbering system.
16. Secondly, and more fundamentally, entitlement to state pension and contributory social security benefits is based on the number of weeks in a tax year for which contributions have been paid or, where credited or collected at zero%, treated as having been paid. This principle underlies Class 1, existing Class 2, Class 3, NIC credits, European Economic Area rules and certain international social security agreements.
17. The proposals in the consultation envisage the government rewriting the rules governing the entitlement of the self-employed to state pension and relevant contributory social security benefits. The proposals do not simplify these rules.
18. We are concerned that both the proposed structure of the new self-employed NIC regime and the way in which benefit entitlements will be determined will not meet the government's objectives (nor comply with our *Ten Tenets for a Better Tax System* outlined in Appendix 1), as they will:
 - simply replace current complexities with new ones,
 - not enable all self-employed individuals to access contributory benefits on an equal basis,
 - introduce new cliff edges around the SPL (below, pay voluntary Class 3 currently costing £14.10pw x 52 = £733.20 for a year to obtain possibly less in benefits than someone with profits of just above the SPL who pays no NIC) and anomalies that are not currently a feature of the self-employed NIC regime.
19. It will also introduce into self-employed NIC the employee NIC anomaly whereby contributory social security benefits including state pension can be accrued without contributing anything, which, we suggest, is not only actuarially unsound but is a long way from what Sir William Beveridge envisaged. Indeed, the proposal to have a 0% NIC band adjacent to a Class 3 NIC profits band is also likely to encourage people to manipulate their profits.

20. Furthermore, under the proposals, the self-employed would still have to be aware of two classes of NIC because those with profits below the SPT or losses would have to consider whether to pay a different Class of NIC (ie Class 3). This would be confusing, and compounded if Class 3 entitles contributors to pensions and other social security benefits different from the new self-employed class of NIC, possibly even having different values depending on whether short-term or long-term benefits are being protected – Class 3 currently only counts for long-term benefits, so any extension to short-term benefits introduces new complexities.
21. The charts in Chapter 2 do not refer to an upper profits limit or the 2% rate above that. We should welcome confirmation that these are intended to continue under the new regime. In this regard, we think that it would be unfair for employees and the self-employed to be treated differently from each other.
22. We should welcome clarification of how the proposals would cater for tax years in which a contributor starts or stops being in business. Would the annual limits apply irrespective of the length of the self-employment or would the profits on which NIC is calculated be reduced by reference to the portion of the year in which the individual is in business, and, if so, would the calculation be by reference to days, or weeks, or months? And how would this be carried through to benefit entitlement? We recommend that the simplest answer is to retain a weekly basis for calculating contributions and entitlement to relevant contributory social security benefits. Retaining a weekly basis for NIC for the self-employed and others in business instead of introducing annual profits tests would keep this class of NIC consistent with Classes 1 and 3 and NIC credits, which all work on a weekly basis, and would obviate the need to redesign the rules governing entitlement to contributory benefits.
23. Example C towards the end of Chapter 2 refers to accounting for Class 3 in the self-assessment return. We should welcome clarification of how the individual would be able to find out how much voluntary NIC is payable, particularly if credits have been awarded, and whether this is a precursor to primary Class 1 being shown on the return (or in the contributor's digital tax account) too. Given the complexity of converting contributions into qualifying years for benefit purposes, the modern tendency for people to change jobs more frequently (with a P45 that does not show cumulative Class 1 NICs paid) and the possibility of credits being awarded (for incapacity, unemployment, universal credit claims, jury service, caring, and overseas employment after the payment of 52 weeks of continuing UK liability), it is extremely hard to see how a taxpayer completing a self-assessment might be able to know how many weeks of Class 3 would be needed to make the year qualify. We believe the idea of collecting Class 3 through the ITSA system to be thoroughly misconceived and impracticable, even before considering the position of the 20 million-plus earners who are outside ITSA.
24. We reiterate the need to consider the international aspect, including whether social security agreements will need to be renegotiated to fit in with any of the proposals, especially in the light of references in the document to contributions/benefits formulae.

RESPONSES TO SPECIFIC QUESTIONS

Chapter 2: A reformed Class 4 NICs and an annual profits test

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

25. We consider that the government should maintain the existing level of access to contributory benefits so that the ability to access and the NIC cost to those in business of accessing contributory benefits and state pension are similar to the costs incurred by contributors in business under the current system. This would inter alia mean retaining the right for those in

business (as well as traders) to pay self-employed NIC at a rate similar to existing Class 2 where trading profits are small (ie below the SPT) or non-existent because the business profit is not from a trade, or losses are made.

26. Our recommendation as to how this should be achieved is set out above.

Question 2: This chapter explains the government's proposed 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 and 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?

27. We have no objection to merging Classes 2 and 4 NIC as this should conceptually make self-employed NIC seem simpler. However, we believe that Class 4 should be merged into Class 2 rather than the other way round. Entitlement to state pension and contributory social security benefits is based on the number of weeks in a tax year for which contributions have been paid or, where credited or collected at zero%, deemed to have been paid. A large number of self-employed workers also pay Class 1 NICs, and they already understand the need to combine Class 1 working weeks with Class 2 paid for weeks of self-employment. Class 4 NICs are widely seen as a tax.
28. We feel that, unless the government intends to rewrite the rules governing rights to state pension and relevant contributory social security benefits (and potentially renegotiate certain cross-border social security agreements), the basic proposals in the document to base entitlements on annual profits need rethinking. The document discusses at some length how to deal with the complexities of short-term benefits such as maternity allowance, which is currently addressed by allowing a woman to pay voluntarily in advance for the requisite number of weeks. Staying with a weekly base for the future should reduce that complexity.
29. We are concerned that structuring the new Class 4 NIC for the self-employed in the same way as Class 1 NIC for employees will not only create unfair cliff edges but will make the system more complicated than the present system. It will also introduce into self-employed NIC the anomaly that contributory benefits including state pension can be accrued without contributing anything, which is a long way from what Sir William Beveridge envisaged. It would also mean that those living on capital and investment income rather than running a business would have to pay £733 per year more than those with self-employed profits between the SPT and the LPL to buy lesser benefit entitlements, which seems conceptually wrong.
30. The present system for Class 2 NIC is seen as broadly fair, as everyone contributes the same amount (of Class 2 NIC) to qualify for the same contributory benefits, and the greater the profits, the greater the (Class 4) NIC liability.
31. However, under the proposed system, unfairness will arise where profits are around the SPT. Using the current SPT of £5,965, annual profits of £5,966 (or in a band up to £8,060) will entitle the contributor to a qualifying year at a NIC cost of £nil, whereas a qualifying year where annual profits are £5,964 would cost the contributor $£14.10 \times 52 = £733.20$ in voluntary contributions. This cannot be seen as logical or fair.
32. Complexity will arise because the contributors with profits below the SPT will have to decide whether to pay Class 3 NICs. This complexity will be exacerbated if Class 3 entitles contributors to pensions and contributory social security benefits which are different from those 'bought' by the newly merged Classes 2 and 4 NIC.
33. We therefore recommend that the new self-employed NIC regime should be a merger of the Classes 2 and 4 rules.

Question 3: What are your views on the proposed contributory tests 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 and Support Allowance?

34. a. *State pension*: we are content with the proposal to continue using the current rules.
35. b.& c. *Bereavement support payment and employment & support allowance*: We assume that the proposed change is because the new self-employed NIC will be based on annual profit periods. Rules would be needed to set out how entitlement to contributory benefits would accrue where the contributor was not self-employed for the whole year. Our suggested solution outlined above would cover this need.

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?

36. We think that most people, even the self-employed for whom Class 2 NIC is a separate outgoing and for whom both Classes 2 and 4 NIC are visible (unlike for employees), are not sufficiently aware of the credits provisions in the NIC system that protect entitlements. The same applies to recipients of child benefit and other state benefits which entitle recipients to NIC credits.
37. We recommend that any change be accompanied by publicity, telling people what they get in return for paying NIC, and, similarly, given the unpopularity and cliff edge impact of high income child benefit charge, claiming or being eligible for child benefit. Adopting our recommendations for restructuring set out above, in particular to retain weekly profits periods and name the contribution Class 2 rather than Class 4, would help reinforce the message.

Question 5: Do you agree that the government should align voluntary contributions (i.e. by making Class 3 the only voluntary NICs payment) for the new State Pension for employees and the self-employed? Please give reasons.

38. We consider that the self-employed, whether they are making large or small profits or losses should accrue the same benefits for equivalent payments of NIC. It is also anomalous to be able to accrue entitlement to contributory pension and social security benefits without paying anything, especially where, as proposed in the document, there would be a cliff edge for the self-employed depending on whether profits were just above the SPT (pay no NIC but accrue full benefit entitlement) or just below SPT (pay Class 3 costing $£14.10 \times 52 = £733.20$ for a year).
39. In addition, any changes to the UK rules concerning the way in which voluntary (or compulsory) NIC buys benefits or which involve abolition of Class 2 would need to interface with the rules of other countries and our cross-border social security agreements.
40. On these bases, as noted above, the simplest approach for a new self-employed NIC would be to adopt our recommendations set out above, which includes retaining a voluntary Class 2 NIC for traders with small profits or losses or for others in business, such as certain landlords, at the same rate as our suggested flat Class 2 rate for those whose profits exceed SPT.

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 and Support Allowance?

41. In the interests of equity, the self-employed and employees should as far as reasonably possible have access to the same contributory benefits and should bear similar contribution burdens at similar levels of income.

Question 7: Do you agree that the government should consider facilitating this access through Class 3 voluntary contributions?

42. Such benefits should be able to be accessed through voluntary contributions, be that Class 2 or Class 3. There is an argument, if the self-employed are to be asked to pay Class 3 contributions to protect benefit entitlements, that Class 3 should also be reformed and be set at a lower rate than Class 2 to reflect the fact that the benefit entitlements purchased are less worthwhile.

Chapter 3: 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:

- 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

43. The proposals would be even more difficult to understand than the present rules, and therefore do not meet the government's stated objectives. Adding complexity to the benefits legislation reduces the advantage to be gained from merging Classes 2 and 4.

Question 9: Can you suggest any alternatives?

44. We suggest that the maternity allowance rules be changed only so far as is as necessary to fit in with our recommended approach set out above.

Chapter 4: 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?

45. If government adopts our proposal above, then this would cover periods when the contributor is self-employed.

Chapter 5: 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?

46. The groups listed have special rules for specific reasons that would not seem to have changed. Unless the circumstances giving rise to and policy underpinning the modified regime for these two classes of worker have changed materially, we do not think it would be appropriate to terminate their special arrangements, so recommend that under any new structure the rules should operate to leave them in a similar position to currently. We would note in particular that volunteer development workers are the subject of international agreements.

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?

47. If these classes of employee are not eligible to pay a new merged self-employed NIC then they should be allowed to accrue benefit entitlement by paying voluntary Class 3 NIC. It is, though, not clear why those employed abroad in non-treaty states (by UK employers after 52 weeks of absence, and by all host state employers) are entitled to pay Class 2 in exchange for better benefit entitlements than UK residents who have to pay the more expensive Class 3.

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?

48. The groups listed have special rules for specific reasons. Unless the circumstances giving rise to, and policy underpinning, the modified regime for these groups have changed materially, we do not think it would be appropriate to terminate their special arrangements, so recommend that under any new structure the rules should operate to leave them in a similar position to currently.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
4. **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via <http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax>).