

# Tax Representation



## TAXREP 37/08

### NATIONAL INSURANCE CONTRIBUTIONS: IMPROVING COLLECTION FROM THE SELF EMPLOYED

*Memorandum submitted in June 2008 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to a consultation document published in March 2008 by HMRC*

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# NATIONAL INSURANCE CONTRIBUTIONS: IMPROVING COLLECTION FROM THE SELF EMPLOYED

## INTRODUCTION

1. We welcome the opportunity to comment on the proposals in the consultation document published by HMRC on 12 March 2008 at <http://www.hmrc.gov.uk/budget2008/ni-collect-class2-condoc.pdf> with an impact assessment at <http://www.hmrc.gov.uk/budget2008/ni-collect-class2.pdf>.
2. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in Annex A. Our Ten Tenets for a Better Tax System which we use as a benchmark are summarised in Annex B.

## KEY POINT SUMMARY

3. We consider that the best way of simplifying the collection of NIC from the self employed would be to:
  - charge Class 2 NIC at nil per cent - thereby eliminating the need to collect it and therefore costs of collection;
  - update the contribution records of the self employed by reference to periods of self employment - using information that the self employed are already obliged to supply to HMRC; and
  - make up exchequer revenue loss by either increasing the main rate of Class 4 or extending the profit bands on which Class 4 NIC is collected - on a revenue-neutral basis.

This would be in line with the spirit of the recommendations made in 1998 by Martin Taylor in his report on modernising Britain's tax and benefits system: 'Work Incentives'.

4. Failing that, if we are to continue to have two classes of positive-rated NIC for the self employed, then the current system of notification, collection, exemption and deferral works reasonably well but could be improved to save costs and improve collection by making a number of relatively minor changes. We suggest the following:
  - Quarterly billing of Class 2 NIC should cease and payment of Class 2 NIC by direct debit should be encouraged by HMRC, eg by more active marketing and provision of incentives. The amounts collected each month should continue to be for 4 or 5 weeks as at present.
  - For those who do not pay by direct debit, Class 2 should be collected via the SA statement in two instalments, payable on 31 January and 31 July with SA tax and Class 4 NIC. The 31 January SA statement would collect Class 2 payments for the half-year period from April to September previous and the 31 July SA statement would collect Class 2 for the half-year period from October to April previous, ie in arrears.

- The SA statement should show clearly all tax and NIC liabilities due to/from HMRC, including Class 2 NIC and any arrears thereof, stating to which period the amounts relate and the due dates.
- Where Class 2 NIC is being collected by direct debit there should be a note on the SA statement stating that the contributor should take no action in respect of the Class 2 NIC because it is being collected by direct debit, and all amounts collected by direct debit should appear on the statement.
- Agents should be permitted to make and renew deferral and SEE applications on behalf of clients.
- Telephone claims should be allowed for deferral and SEE applications and renewals.
- Ideally the requirement to renew SEE and deferrals should be abolished – however where SEE or deferral is in place, we recommend that the SA statement is used to draw attention to this fact and to the circumstances in which it may no longer be appropriate.
- Interest should be charged on late paid Class 2 NIC, replacing the anachronistic ‘highest rate’ regime, although the low value of Class 2 contributions makes any interest charges very insignificant, so this change should be a low priority.

5. In the longer term, given the burdens on business and government of having to administer and collect NIC which is an additional tax of great complexity and the fact that the safety net of the benefits system means that, for many, a lack of contributory benefits is compensated for by other, possibly means-tested, benefits, what is needed is a review of the social security system as a whole (ie NICs and all benefits, whether or not contributory, means-tested, or administered by central government or local councils) with a view to abolishing the need for a contributory levy, or making it obviously worthwhile in a way that makes people respect the system, rather than treat NICs as a poorly disguised tax. Classes 2 and 4, for example, were designed in a different economic environment and for different purposes. It is time for a root-and-branch review involving both social security and tax considerations, rather than just minor cosmetic tinkering with late-paid Class 2 quarterly bills and the like.

## **GENERAL COMMENTS**

6. The current system for NIC requires the self-employed in this country to pay two Classes of NIC, namely Class 2 and Class 4. Class 2 contributions give entitlement to certain State benefits. Ideally these NICs should be paid as the liability arises, because they need to be recorded on a contributor’s contribution record timeously in order that entitlement to benefits can be ascertained in the event of a claim by the contributor. Although Class 4 NIC collected by government is used for the same purposes as Class 2, ie, it is paid into the National Insurance Fund and to the NHS, Class 4 gives no entitlement to State benefits so is in effect simply a tax on the self-employed, which can be collected in arrears like income tax.

7. Benefit entitlement is generally based on Class 1, 2 and 3 NI contributions made in the two, and sometimes three, complete tax years prior to the date of claim so it is important that contribution records are kept as up-to-date as possible. The benefits year starts on the first Sunday of the January following the tax year, so contributors' records need to have been updated by then if benefit entitlement is to be ascertained correctly.
8. Given current policy that Class 2 NICs give entitlement to State benefits but Class 4 NICs do not, we consider that the regimes for collecting both classes of NIC are appropriate but could be improved with some relatively minor changes. Payment of Class 2 by monthly direct debits should be encouraged. Basing the amounts payable on 4 or 5 weekly amounts, as at present, rather than say one twelfth of the annual amount, is appropriate.
9. As people expect an organisation to issue one statement, the SA statement should be used as the main way of communicating Class 2 NIC liabilities, including arrears, to contributors.
10. For those who do not pay by direct debit, the liability should be collected in arrears via the SA statements on 31 January and 31 July, rather than via quarterly billing. The 31 January SA statement would collect Class 2 payments for the period from the previous April to the previous September (to be precise, the weeks from the first Sunday following the previous 5 April to the first Saturday in the previous October) and the 31 July SA statement would collect Class 2 for the period from the previous October to 5 April (to be precise, for the weeks from the first Sunday in the previous October to the first Saturday following the previous 5 April), ie always in arrears.
11. So for example, for non-direct debit contributors, the SA statement at 31 January 2008 would have collected Class 2 liability for the first half of 2007/08 (8 April to 6 October 2007) and the SA statement for 31 July 2008 would collect the contributor's Class 2 liability for the second half of 2007/08 (7 October 2007 to 5 April 2008). (There would be no change to the way in which Class 4 is collected.)
12. On the assumption that the SA statements have a cut-off time of about six weeks before the due date, this would give HMRC from the beginning of October to say mid-December (ie two-and-a-half months) correctly to state the Class 2 amount payable for the preceding April to beginning of October period in the 31 January SA statement and from the beginning of April to say mid-June (ie approx two-and-a-half months) correctly to state the amount payable for the preceding October to April period in the 31 July SA statement.
13. For those who do pay by direct debit, the SA statement should refer to the liability as being paid by direct debit and note the amounts received. If the SA statement is used as proposed, then quarterly billing of Class 2 can be abolished.
14. Quarterly billing for Class 3 could also be abolished, as we doubt that it is used much in practice because most payments are likely to either be made after the year end or regularly during the year using monthly direct debit where contributors have no other NI liability. Paying Class 3 in year can cause problems if there are credits awarded elsewhere or if there are Class 1 earnings or Class 2 payments.

15. It is vital that SA statements are very clear, in particular when dealing with arrears of NIC. They must also incorporate any NI credits (eg, for periods of incapacity) so that overpayment may be avoided. This might make the IT very complex, but the end result should be a simpler statement of total current liability.
16. However, the above recommended improvements to the collection of Class 2 NIC are merely patching up something which is an unnecessary impost. It has been proposed by some, including Martin Taylor in his 'Work Incentives' report published on 17 March 1998 (<http://www.hm-treasury.gov.uk/media/D/8/taylor.pdf>) that Class 2 NIC should be abolished and merged into Class 4, which should then entitle contributors to State benefits. However, the contributory principle means that contributors' records need to be updated by the first Sunday of the January following the tax year in respect of which contributions have been paid. If Classes 2 and 4 NIC are to be merged, contributions would need to be based on current year profits as determined by the SA return which may not have been filed by that date.
17. We therefore suggest an alternative approach. Class 1 NIC is charged at nil per cent between the lower earnings limit and earnings threshold. A similar approach could be taken for Class 2 NIC liability whereby the rate for all Class 2 NIC would be at nil per cent.
18. In order to ensure revenue neutrality, the rate at which Class 4 NIC is charged could be adjusted (an increase of approximately ½% would raise in the region of £175 from those on the highest profits) or the profits limits between which the current eight per cent rate of Class 4 NIC is charged could be adjusted. At current rates, the latter proposal would mean extending the band on which eight per cent is applied to approximately £1,495 of profits.
19. Further research would be needed to identify the appropriate amount to make it revenue-neutral – in the interests of encouraging businesses, we do not agree with Martin Taylor's suggestion (para 2.28) that such a change might be revenue-raising. Our proposal would eliminate the cost of collection of Class 2 NIC without loss of NIC revenue.
20. In the longer term, given the burdens on business and government of having to administer and collect an additional tax of great complexity and the fact that the safety net of the benefits system means that, for many, a lack of contributory benefits is compensated for by other, possibly means-tested, benefits, what is needed is a review of the social security system as a whole (ie NICs and all benefits, whether or not contributory, means-tested, or administered by central government or local councils) with a view to abolishing the need for a contributory levy, or making it obviously worthwhile in a way that makes people respect the system, rather than treat NICs as a poorly-disguised tax. Classes 2 and 4, for example, were designed in a different economic environment and for different purposes. It is time for a root-and-branch review involving both social security and tax considerations, rather than just minor cosmetic and ad hoc tinkering with matters such as late-paid Class 2 quarterly bills, and we would welcome the opportunity to become involved if there was a prospect of such a review leading to changes for the better.

## ANSWERS TO QUESTIONS AND DETAILED COMMENTS

### Information provided to contributors

*Would the incorporation of a notification of arrears of Class 2 within the SA statement help contributors' understanding of any outstanding liabilities and increase the likelihood that more people would pay their contributions earlier?*

21. Yes, it might for those who are in arrears but only if the explanation on the SA statement is clear. For example it should include the reference to Class 2 NIC, the amount outstanding, the due date, the period to which the outstanding contributions relate and the fact that it is payable in addition to the SA amounts shown. We do not necessarily believe that the format in the example given in Annex B is the most appropriate because it misleadingly implies a later due date for the Class 2 NIC, when it is in fact already overdue. A prominent note on the statement could highlight the potential loss of benefit entitlement if a contributor fails to pay.
22. The approach suggested is unlikely to increase the likelihood of contributions being paid earlier. We believe that payment by monthly direct debit of Class 2 should be actively encouraged to achieve this objective.

### Timing of liabilities

*(i) Would either a reduction of the number of payment dates or closer alignment of the dates when Class 2 contributions became due with those for Class 4 liabilities under SA aid contributors' understanding of any outstanding liabilities?*

23. Simply reducing the number of payment dates or closer alignment of the dates would not aid contributors' understanding of outstanding liabilities or the distinction between Classes 2 and 4. 'Understanding' would not seem to be the problem that is troubling HMRC: the document suggests that contributors on quarterly billing just pay late, despite having been sent a bill showing the liability. Class 2 NIC is paid from the start of, and during, the period of self-employment but SA tax and Class 4 NIC payments are initially due much later than the start of self-employment and may be payable after self-employment has ceased.
24. As noted above, it is very important that it is made clear on statements to which period the Class 2 contributions relate.

*(ii) Do you agree with our assessment of the costs and benefits for the self employed set out in the impact assessment?*

25. We have not carried out analysis to enable us to answer this question but have the following general comments about the basis used. Some of the cost benefits expected by HMRC arise from expecting fewer queries on quarterly statements. These queries will probably simply be transferred to SA helplines on receipt of the SA Statement of Account by taxpayers. The SA helplines are still part of HMRC so there would not be a cost saving. However, if the information provided on SA statements in connection with Class 2 NIC arrears and demand notes was improved, and the accuracy of the notifications was improved, there would be likely to be less calls to HMRC helplines and therefore cost savings to HMRC.



26. A strategy of improved information and clarity on statements and demands for payment might produce similar savings to those envisaged and be less expensive to implement and less likely to be prone to unexpected problems.
27. For example, the existing demands for payment have no detail about arrears, only a comment stating that they arose before a particular date. If more detail was provided, many enquiries would be saved. When a quarterly bill goes astray in the post, the reminder has no information at all except the total amount due. Again, if the detail was repeated (as it is on an SA statement), taxpayers may not need to telephone HMRC to find out to what the reminder relates. The specific reason for a statement being issued should always be stated, eg normal quarterly bill, or 'you did not send back the direct debit form', or '(you started in self employment on and) you need to pay contributions for the period before your direct debit commenced', or 'the arrears amount has been adjusted' (and give reason) or 'your SEE has expired'.

*(iii) Would you welcome SA statements that incorporated current National Insurance Class 2 liability as well as arrears information?*

28. Yes we would. We believe that, for contributors who do not pay by direct debit, including Class 2 NIC on the SA statement would be the simplest way of collecting it.
29. However, we believe that using the SA statement as a means of notifying arrears which are to be collected by a separate bill or method would confuse unless it is made quite clear that the reference to Class 2 NIC on the SA statement is a memorandum note and it states clearly that the amount is due and will be collected separately. Two notifications would just confuse rather than simplify.
30. Class 2 is payable in respect of a week so the amount payable for a year depends on how much time during the year that the contributor was a self-employed earner. It should, however, still be possible to collect Class 2 entirely using the SA arrangements because the contributor is already obliged to notify HMRC when he starts and ceases self-employment. For those who do not pay by direct debit, the Class 2 liability could be payable twice yearly in two instalments on 31 July and 31 January in-year. Although this would mean that HMRC, in some cases, would have to send out an SA statement only to collect Class 2 NIC (for example, where there is no payment on account collectable), this would still be less paperwork than quarterly demand notes. It would also have the benefit that taxpayers see, in one place, the extent of their indebtedness to HMRC at a particular time.

*(iv) Would the bringing together of information in this form make it less likely that you or your clients would get into arrears (particularly in respect of Class 2)?*

31. Some, but not all, taxpayers do get confused by the number of demands they get for payments of monies due to HMRC (tax and NIC). Under self-assessment, all income tax and Class 4 NIC is collected using one statement and we believe that NIC should be collected via that same statement for those who do not pay Class 2 by direct debit.

### **Consequences for late payment of contributions**

*Would the replacement of the current 'highest rate' provisions for late paid Class 2 contributions with interest charges in line with those due on late Class 4 contributions*

*(as part of wider SA liabilities) assist people's understanding of the basis for additional payments due as a result of late payment?*

32. On the face of it, the 'highest' rate provisions are anachronistic because SA tax and Class 4 NIC attract interest and surcharges if paid late. However, the due date for payment of Class 2 NIC depends on how a contributor pays and raises the question of what should be the date from which interest on late paid Class 2 runs.
33. Currently the highest rate applies only if the Class 2 NIC is paid more than one complete tax year after the tax year to which it relates and there is therefore no financial incentive to pay Class 2 NIC earlier.
34. Charging interest and surcharges in the same way as on SA tax would conceptually be easier for contributors to understand and that in itself is likely to bring late paid contributions in earlier. We appreciate that this would require a change in legislation. It might also need a punitive rate of interest and surcharge to have any effect, since Class 2 rates are fairly insignificant to most payers already, but this would undoubtedly be unpopular.

*Would a consistent interest based charge across both Classes 2 and 4 be easier to verify than the current arrangements?*

35. If interest were to be charged on late paid Class 2, then using the same rate of interest as for other income-based imposts would not only simplify verification but would be logical.

#### **Other areas where improvements could be made**

*Would any practical benefits arise from having a single direct debit arrangement encompassing both SA and Class 2 liabilities? Would such an arrangement encourage a greater take up of direct debit as a means of payment?*

36. We believe that collection of SA and NIC liabilities by direct debit could be a way forward if HMRC can provide a good customer experience. The widespread use of direct debit by commercial organisations demonstrates that people are happy to pay monthly, or even quarterly, accounts by direct debit, even where the amounts may vary between payment dates, for example in the case of credit card bills. The popularity of direct debit may be because regular payment assists budgeting and may also be because the commercial organisations offer incentives (ie, discounts) to customers who pay by direct debit and, most importantly, these organisations provide a satisfactory customer experience.
37. However, whilst some contributors are happy to make their regular Class 2 NIC payments by direct debit, many are unlikely to be prepared to pay their SA liabilities by this method. This is because the SA amounts demanded can vary significantly between one six-monthly payment date and the next, may be substantial, and taxpayers generally are likely to want to have control over the amount and exact timing of significant payments. In addition, there is widespread low opinion of HMRC service standards. If an error is found on a statement, the current experience is that it is not always very easy for a taxpayer or an agent to contact anyone within HMRC to have errors corrected on a timely basis. Given this, we believe that a significant number of taxpayers will not want to pay their SA liabilities by direct debit. Indeed, if there was a



proposal that contributors who pay Class 2 NIC by direct debit should pay their SA liabilities by direct debit as well, then we believe that many would cancel their Class 2 NIC direct debit mandates.

38. Greater take up of payment of Class 2 NIC by direct debit, would reduce costs for HMRC and helps contributors budget, so we suggest that HMRC should actively market direct debit as a method of paying Class 2 NIC to contributors who do presently not use that facility. HMRC could also make it easier to 'opt in' to direct debit payment by being able to set them up by telephone followed by a written confirmation like other organisations offer, so that contributors do not need to complete forms and send them back.
39. In addition, we believe that the uptake of direct debit as a method of payment of Class 2 NIC could be improved by giving a discount for paying by direct debit, in the same way as commercial organisations do.

*Would the removal of the need to re-apply for the small earnings exception be welcomed as a simplification?*

40. We agree in principle that the requirement to re-apply for the SEE every three years should be removed, but only if HMRC introduce certain safeguards. It would be a simplification measure for many contributors, but may mean that some contributors will not pay Class 2 NIC when they should be doing so, either because their earnings exceed the threshold or because they will lose entitlement to State benefits if they do not do so.
41. HMRC should be able to identify from SA returns those taxpayers who are no longer eligible for the SEE because their earnings are over the threshold. Although this, at best, is likely to come to light two or three years after the individual should have notified HMRC that they were no longer eligible for SEE, an immediate warning notice would stop arrears building up for several years.
42. In order to remind contributors of their position, in the same way that it is proposed that details of Class 2 contributions should be included on SA statements, the SA statement should also include a note about the SEE in place and reminding contributors (probably by way of any explanatory note) that they should check if they are still eligible or would benefit from paying contributions.
43. These suggestions are in line with the principle that as much tax and NIC payment information should be included in a single communication to taxpayers, ie the SA statement.

*Would the removal of the requirement to re-apply for deferment of Class 2 and Class 4 contributions for self-employed people who are also employed and anticipate paying the annual maximum contributions be welcomed?*

44. This would be most welcome in principle. However, in order to reduce the risk of underpaying Class 2 and 4 as a result of a change in circumstances, we suggest the same approach is taken as is suggested for the SEE above and a note is included on SA statements where deferral is in place.

45. As it will be some time before changes can be implemented, we suggest that the current re-application for deferral of NIC could be made less onerous and time-consuming for contributors and their agents. It would save them and HMRC time and costs if an agent could make the claim on behalf of a client by telephone (or on paper) rather than the claim needing to be signed by the contributor and submitted on paper. The risk of loss of NIC is low because any underpayment of Classes 2 and 4 will be identified when the deferral is reviewed by HMRC, which process seems to take place in spring/summer after the tax return filing deadline of 31 January. It is therefore very unlikely that more than two years of arrears could build up without being identified under the existing processes.

PCB/AW  
6.6.08

**ICAEW AND THE TAX FACULTY: WHO WE ARE**

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter *TAXline* to more than 10,000 members of the ICAEW who pay an additional subscription.
4. To find out more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at [taxfac@icaew.com](mailto:taxfac@icaew.com) or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

## THE 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 <http://www.icaew.co.uk/index.cfm?route=128518>.