

Introduction

This section describes the main rules of national insurance contributions (NICs) for the self-employed. Employers, too, might find parts of this section useful in cases where they have disputes with the National Insurance Contributions Office (NICO) over whether workers are self-employed or employees. Where workers previously treated as self-employed are recategorised as employees, employers could be faced with substantial NIC liabilities, most of which they cannot recover from the workers.

- The National Insurance Fund is a 'pay as you go' fund with current benefits, such as state pensions, maternity and sickness benefits, currently being more than covered by contributions made by the working population.
- The total cost of social security benefits substantially exceeds NIC income, with the shortfall made up from general taxation.
- The NICO operates the NIC system within HM Revenue and Customs (HMRC).
- The NICO has its head office in Newcastle upon Tyne and local offices around the country.

The self-employed category

It is important for employers to distinguish between employed and self-employed earners and to ensure that the categorisation is accepted by the NICO. There is a substantial difference in NICs between the two categories – NICs for employees and their employers are very much higher than NICs for the self-employed, especially for high earners – and employers have the obligation to deduct tax and NICs under pay as you earn (PAYE) for employees.

- Often, it is clear where people are engaged in business on their own account, or in partnership with others: these people are clearly self-employed.
- Each local tax and NICO office appoints an officer to deal with categorisation, and each will accept the other's decision provided they are satisfied all the relevant information has been provided.
- However, the NICO will often decide categorisation at the outset of the individual's self-employment, whereas a tax office might look at the question at a later date, when more facts are apparent about how the individual operates.
- If the tax office comes to a different conclusion from the NICO, recategorisation will probably be sought.

The NICO decision

The NICO uses various tests in deciding whether someone is employed or self-employed. The following are the most important:

Contract of service or a contract for services

- A contract of service is generally seen as employment and a contract for services is generally seen as self-employment.

- A written contract alone cannot be decisive, but is helpful in establishing status if the facts back it up.
- Whether or not there is a written contract, the NICO will look closely at the way in which the work is performed, the terms and conditions that apply, and the mutual obligations that are incurred.
- Set hours, holiday and overtime pay, and supervision of the work done tend to indicate an employment. So does a continuing and dependent 'master/servant' relationship.
- Indications of self-employment include:
 - An agreement for a specific amount of money, or commission, for the work to be done (rather than regular weekly or monthly pay). Recent decisions in tax tribunals and the High Court have highlighted 'project-based' terms as an important factor.
 - Freedom to accept or refuse work that is offered.
 - Freedom to accept work elsewhere.
 - The right to substitute someone else rather than do the work personally. Where genuinely present, this is usually a clear indicator of self-employment.
 - Having one's own public liability insurance.

Control

- Where there is a right to control the duties of the worker and how they are performed, the NICO will argue that a contract of service exists, even if the control is not normally exercised. Another pointer is the right to suspend or dismiss the worker.
- Under a contract for services, it is usual to find that the person doing the work has a substantial measure of control over the method, timing and performance of the task, and that they normally work without supervision.

Integration

People who are integral parts of the business activities and organisation are likely to be employees. However, where the services rendered are accessories to the business, self-employment is indicated.

Economic reality

The NICO will look at the following aspects in deciding whether or not someone is running a business of their own.

- Do they provide their own equipment, especially major items?
- Do they hire any helpers needed, paying them out of their own pockets?
- Is any financial risk being taken?
- Are they using their own money, meeting losses as well as taking profits, correcting unsatisfactory work in their own time and at their own expense, etc?
- Is there any kind of a business-like organisation?
- This is likely to include responsibility for investment and management in connection with the work, or any opportunity to profit from sound management of it.

Special cases

The NICO sometimes resolves difficult or inconvenient cases by making regulations to treat workers as employees.

Some of the most common circumstances in which this happens are:

- Domestic workers and office cleaners.
- Most agency workers, for example, secretaries, nurses, teachers, draughtsmen, computer programmers, etc, who obtain temporary work through agencies.
- Many lecturers and instructors if they are not clearly already regarded as employees under the normal rules.
- The same applies to many ministers of religion.
- Workers in the film and television industry.
- HMRC has accepted some categories of freelance and casual workers in these industries as being self-employed for tax purposes, and has stated that those who do not fall within the prescribed categories will be treated as employees. The NICO normally follows the tax guidelines in these cases.
- Entertainers.
 - Many actors and entertainers are categorised as employees for NICs, although they may remain self-employed for income tax purposes.
 - It is often beneficial for entertainers to be treated as employees for NICs, as it gives them entitlement to jobseeker's allowance during periods without work.
- Labour-only contractors.
 - Many workers claim to be independent contractors supplying services on a self-employed basis.
 - These include sales representatives, driving instructors, construction and agricultural workers, catering staff, and journalists.
 - The NICO and tax offices have increasingly recategorised many of these people as employees, especially where they work mainly for one business. Tax offices and the NICO particularly keep the construction industry under review to ensure compliance. Incorrectly treating workers as self-employed could result in backdated reclassification and will include interest and penalties in some cases.

There have been some notable court cases concerning individuals working in these trades and professions, who have been successful in establishing their self-employed status. The up-to-date position should always be carefully checked before accepting that a regulation applies. Where it is possible to have a different status for tax and NICs, this might be worth considering, because employee status for NICs can improve eligibility for state benefits. However, the NICs payable by the employer and employee combined are much higher than the NICs payable by a self-employed individual.

Salaried partners

Partners in a business are normally self-employed, but partners on fixed salaries may be treated as employees, even where they might also receive profit-related bonuses. The categorisation will depend upon the extent to which they are parties to the full partnership agreement, including any arrangements for winding up the business.

Personal service companies

Companies that provide organisations with the services of one or more individuals have to pay NICs on a deemed salary calculated according to special rules. The purpose of these rules, known as IR35, is to prevent avoidance of tax and NICs through payment of dividends, on which NICs are not payable.

- The rules apply where a worker provides services through an intermediary, usually a one-person company, and if the worker had contracted directly with the client under the same terms, the income would have been taxed as employment income.
- The intermediary has to pay NICs (and make PAYE tax deductions) on any income not paid out as employment earnings, subject to certain limited deductions for the company's expenses. This income is called the deemed payment.
- The deemed payment is part of the worker's taxable income and is deductible in computing the company's profit liable to corporation tax.
- Where the worker falls within one of the categories for which income would be treated as employment income for NICs but not for income tax, the intermediary only has to pay NICs and not make PAYE tax deductions.

Earnings

Self-employed people may be liable to Class 2 and Class 4 contributions. Class 1 contributions, primary and secondary, are paid by employees and their employers respectively. Class 3 contributions are voluntary and may be paid where a contribution record is incomplete to improve a person's entitlement to benefits.

Class 2 contributions

Class 2 NICs are charged at a flat rate and are not earnings-related. It is nevertheless necessary to establish the actual net earnings for the year, because if they are below the small earnings exception limit, no contributions are due. The actual net earnings for the year are the net profits shown by the business accounts for a tax year, which runs from 6 April to the following 5 April. If the accounting year straddles 5 April, the profits or losses must be apportioned for this purpose.

Class 4 contributions

Earnings for Class 4 purposes are the profits that are chargeable to income tax, after adjusting for items such as capital allowances and trading losses.

Some further items that can be deducted for income tax, such as personal allowances, are not deducted for Class 4 purposes.

- Class 4 earnings correspond with the tax year in which the profits are assessed for income tax.
- Therefore if taxable profits of £20,000 are earned in the accounting period ended 30 April 2009, they are assessed for 2009/10 (accounting period ending within the tax year, except generally at the start and end of self-employment, for which there are special rules).

Losses

The treatment of losses for NICs can be different from the income tax position. If trading losses are set off against income from other sources, such as dividend income, instead of being carried forward for tax purposes against future trading profits, the losses can still be carried forward for Class 4 purposes.

Example

		£
Profits	30 April 2008	8,000
Losses	30 April 2009	4,000
Profits	30 April 2010	15,000
Assessable	£	£
2008/09		8,000
2009/10 (Losses set against other income for tax purposes)		Nil
2010/11	15,000	
Less losses b/f	(4,000)	
Profits for Class 4 purposes only		11,000

Although profits of £15,000 are taxed for 2010/11, only £11,000 is taken into account when calculating the Class 4 NICs payable.

Two or more income sources

Earnings from more than one source of self-employment must be added together when calculating both Class 2 and Class 4 NICs.

Working tax credit and New Deal incentives

Payments of working tax credit (WTC) and grants under the New Deal scheme do not count as earnings liable to Class 2 or Class 4 contributions. The New Deal scheme and certain WTC payments to people over 50 are aimed at helping people take up employment or self-employment.

Contributions

Changes in the rate of NICs normally take place at the start of the tax year (6 April). The rates are given below.

Class 2 contributions

	2008/09	2009/10
	£	£
Weekly flat rate	2.30	2.40
Small earnings exception limit	4,825	5,075
Maximum payable	121.90	127.20

- The flat rate contribution is normally payable by self-employed people for any week in which they are over the age of 16 and under pensionable age.
- Pensionable age is currently 65 (for men and for women born after 5 April 1955) and 60 (for women born before 6 April 1950).
- For women born between 6 April 1950 and 5 April 1955, a sliding scale fixes the age at which contributions will cease.
- Pensionable age will eventually rise further for both sexes, with the first set of changes due to be phased in from 6 April 2024.
- Self-employed earners may claim exception from liability if they have low income.
 - They should apply to the NICO for exception where earnings from self-employment are expected to be less than the small earnings exception limit – see table above.
 - If exception is approved, a certificate is issued for a period that can be as long as three years, and will end on 5 April.
 - The certificate can be backdated for 13 weeks only, and so some NICs might be paid unnecessarily if application is not made in good time.
 - In the case of an ongoing business, some evidence, such as accounts or details of receipts and payments, must be provided with the application.
 - For a new business, it is only necessary to state that earnings are expected to be below the limits.
 - If the conditions for the certificate are no longer fulfilled, it becomes ineffective.
 - One should always inform the NICO of any change in circumstances.
- In practice, the NICO applies some concessions that ignore the strict rules. A self-employment involving a couple of hours a week is ignored.
- No Class 2 NICs are payable by people who are also employees and earn a substantial amount from their employment if their spare-time self-employed earnings are less than £1,300. There is no need to apply for an exception certificate, although the NICO should be informed in writing.
- Class 2 NIC liability does not end during weeks of inactivity or holiday, but there is normally no liability during complete weeks in which the person is entitled to sickness, invalidity or incapacity benefit, maternity allowance, or similar benefits.
- Women who on 6 April 1977 were married, as well as some widows, were entitled to make an election to pay reduced NICs. These elections cease to be effective in circumstances such as divorce or a gap in employment or self-employment, but many elections remain in force. No Class 2 NICs are payable by self-employed married women who have a valid election in force. Reduced NICs do not count towards the state pension.

Class 4 contributions

	2008/09	2009/10
Main rate	8%	8%
	£	£
Lower annual limit	5,435.00	5,715.00
Upper annual limit	40,040.00	43,875.00
Maximum payable at the main rate	2,768.40	3,052.80
Additional rate on earnings above upper limit	1%	1%

- Class 4 NICs are payable at the main rate on self-employed earnings that fall between a lower and upper limit.
- These limits are given in the table above.
- An additional 1% Class 4 NIC is payable on all earnings above £43,875 (2009/10) without upper limit.
- Class 4 NICs are not payable by anyone who is under 16 or has reached pensionable age at the beginning of the year of assessment. The pensionable age rules are the same as for Class 2 NICs.
- A married woman's reduced liability election has no effect on Class 4 NICs.

Annual maximum contributions

An individual who is employed and self-employed in a year may have to pay NICs at the main rate (8% for Class 4 and 11% for Class 1) on both types of earnings, potentially up to the upper earnings limit for each.

Where this occurs, maximum limits on main rate NICs are set to prevent excessive liability.

For 2009/10, the individual then has to pay additional rate NICs at 1% on earnings from each employment that exceeds £110 a week (other than any on which main rate NICs are being paid) and on earnings from self-employment that exceed £5,715 a year if maximum main rate NICs are being paid on employment income.

Maximum yearly NICs at main rate

	2008/09	2009/10
	£	£
Class 1 + 2	3,876.95	4,279.22
Class 2 + 4	2,890.30	3,052.80
Class 1 + 2 + 4	3,876.95	4,279.22

Class 1 plus Class 2 NICs

Where someone is both employed and self-employed in one tax year, or has more than one employment, total primary (employee's) Class 1 NICs at the main rate plus Class 2 NICs must not be more than an amount equal to 53 times the maximum weekly primary Class 1 NICs at the main rate. In practice, if a person's earnings from employment are at least £43,875 in 2009/10, Class 2 NICs are nil because maximum Class 1 NICs are being paid in the employment.

Class 2 plus Class 4 NICs

Where someone is only self-employed, the maximum total Class 2 plus Class 4 NICs at the main rate is calculated as follows:

	2008/09	2009/10
Class 2	£	£
£2.30 x 53	121.90	
£2.40 x 53		127.20
Class 4		
8% of £40,040 – £5,435	2,768.40	
8% of £43,875 – £5,715		3,052.80
Maximum	2,890.30	3,180.00

Class 1, Class 2 plus Class 4 NICs

Where someone is both employed and self-employed, there is a separate annual limit on Class 4 NICs payable at the main rate. The maximum Class 4 NICs payable is limited to:

- The maximum Class 2 payable (£127.20 in 2009/10), plus
- The maximum Class 4 NICs payable at the upper annual earnings limit (£3,052.80 in 2009/10), minus
- Class 2 NICs actually paid, minus
- Primary Class 1 NICs actually paid.

This means that no Class 4 NICs (at the main rate) have to be paid if Class 1 plus Class 2 contributions are equal to or more than £3,180.00 in 2009/10.

Example

In 2009/10, an individual has earnings from employment for 30 weeks at £750 a week, and taxable earnings for the year from self-employment of £20,000.

	£
Class 1 (11% of £750 – £110) x 30	2,112.00
Class 2 £2.40 x 53	<u>127.20</u>
Total	2,239.20

Without the Class 4 limit, Class 4 NICs of £1,142.80 would also be payable (£20,000 – £5,715 x 8%). However, they are limited to the excess of the maximum main rate Classes 2 and 4 payable, £3,052.80, over Classes 1 and 2 contributions paid, £2,239.20, namely £813.60.

Additional rate contributions are payable on the excess of self-employment income over the amount on which the £813.60 Class 4 main rate contributions arise.

£813.60 is £10,170 at 8%.

No Class 4 NICs are payable on the first £5,715 of self-employment earnings.

Therefore additional rate Class 4 NICs at 1% are payable on earnings of £4,115 (£20,000 – £5,715 – £10,170), ie £4,115 at 1% = £41.15.

Deferment

It might not be known during the course of the tax year whether these maximum limits for Class 2 and main rate Class 4 will be exceeded. If a person is in a position where they might be exceeded, they should apply for deferment of Class 4 contributions, Class 2 contributions or both. The application should be made before the tax year starts, but the NICO usually accepts later applications.

- The NICO will reassess the situation after the year end, when all contributions can be accounted for.
- Any additional liability will be payable direct to the NICO, usually between 12 and 18 months after the tax year end.

Benefits

- Class 2 NICs entitle the contributor to most of the contributory state benefits, with the important exception of jobseeker's allowance. Jobseeker's allowance is only available where Class 1 NICs have been paid.
- The payment of Class 2 NICs provides entitlement only to basic allowances and state pension, because the additional or earnings-related amounts (ie the State Second Pension, S2P) are available only where non-contracted-out Class 1 NICs are paid.
- Many benefits require a minimum number of Class 2 contributions, and it is important to check the contribution conditions. Where both Class 1 and Class 2 NICs have been paid at various times, the situation can become complicated, and specialist advice should be taken.
- Class 4 NICs do not provide any entitlement to state benefits whatsoever, and therefore it is particularly important to ensure that Class 4 NICs are not paid unnecessarily.

Collection of contributions

Class 2

- Anyone liable to pay Class 2 NICs must notify HMRC immediately.
- A person will be liable to a penalty if they do not notify their liability for Class 2 NICs by 31 January after the end of the tax year in which they become liable.
- There will be no penalty if there is a reasonable excuse for the failure.

- Where there is no reasonable excuse, the penalty will be a percentage (up to 100%) of the NICs unpaid as a result of the failure to notify.
- The £100 fixed penalty for late notification of liability to pay Class 2 NICs ended on 5 April 2009.
- Notification is usually made at the same time as notification to HMRC of self-employment for income tax purposes, by completion of a single form.
- People generally arrange to pay monthly by direct debit from a bank account. Alternatively, payment can be made by quarterly bill.

Class 4

- The close link with income tax liabilities extends to the collection of Class 4 contributions except where deferment has been granted.
- Class 4 contributions are paid with tax under self-assessment.
- Payments on account are due on 31 January in the year of assessment and 31 July following the end of the year of assessment, with any balance payable on the following 31 January.
- Interest is charged on both tax and Class 4 contributions if they are paid late.

Overseas matters

Class 2 NICs are normally due when someone is self-employed in the UK, and is also ordinarily resident here.

- People who become self-employed outside the UK might wish to pay Class 2 NICs to maintain their contribution record, and they may do so in some circumstances.
- Similarly, someone coming to the UK from abroad and starting self-employment who has not yet established ordinary residence here might wish to start paying Class 2 NICs immediately, and this will normally be possible.
- Class 4 NICs are not due unless a person is self-employed and resident in the UK.

Special categories of self-employed earners

There are special rules for certain self-employed workers. The more important ones are as follows:

Share fishermen

Self-employed fishermen who share the profits of a fishing boat registered in Great Britain pay Class 2 and Class 4 NICs, even though they might often work outside the UK. They pay a special higher rate of Class 2 NICs, and in return qualify for jobseeker's allowance. Their Class 2 rate is £3.05 for 2009/10.

Sub-postmasters

Sub-postmasters are employees of the Post Office but might also be self-employed because they run an attached shop. Although Class 1 NICs are deducted from their salary, the salary is often not taxed under PAYE; instead it is included with shop profits and taxed as income from

self-employment. This is normally beneficial for tax purposes, but special rules are needed to determine the Class 2 and Class 4 NICs.

- The salary is excluded for the purpose of deciding whether earnings are below the small earnings exception limit.
- Where some Class 2 contributions are payable, the annual maximum contributions rules described on page 7, “Annual maximum contributions”, apply in the normal way.
- The gross amount of salary on which Class 1 NICs have been paid is excluded from profits when calculating Class 4 contributions. Class 4 liability might also be limited as a result of the annual maximum rule.

Others

Examiners, outworkers, volunteer development workers, mariners, oil-rig workers and divers are other examples of workers to whom special rules may apply.

Other points to consider

Other points to consider are:

Arrears

- Where Class 2 NICs have not been paid for past periods, the NICO might agree to payment by instalments, but the department has powers to take proceedings in a magistrates’ or higher court.
- Late payments might be charged at a higher rate, and might not qualify for benefits. Interest is not charged on late payments.
- Class 4 arrears are normally associated with income tax liabilities and are dealt with under HMRC’s powers, including penalty and interest provisions. The powers also include the possibility of court action, but arrangements can sometimes be made to pay off the arrears gradually.

Credits and voluntary NICs

Credits are sometimes available to improve an individual’s contribution record for benefit purposes, for example, for young people just starting work, or during and following periods of approved training. No credits are given to self-employed people simply because their earnings are too low to pay Class 2 NICs. In this situation, an individual might want to consider paying voluntary Class 2 or Class 3 NICs. In theory, there is the option to pay Class 3 voluntary contributions, but in practice there is no point, as Class 3 contributions are set at £12.05 a week in 2009/10, compared to £2.40 for Class 2.

People who reach state pension age after 5 April 2010 need to have paid 30 years of contributions to qualify for a full basic state pension. Previously men needed 44 years’ contributions and women 39–44 years, depending upon their date of birth. The reduction limits the need for voluntary contributions.

Repayments

There is no automatic right to repayment if NICs are incorrectly paid, although the NICO will normally reallocate NICs if the wrong category has been paid. If reallocation is not appropriate, a claim for repayment can be made, but this can be a lengthy process. Also, if Class 2 repayments are claimed because earnings are low and exception could have been applied for, the claim must be made by 31 December following the year of assessment.

The NICO annually checks the contribution levels of Class 1 and Class 2. If there is any overpayment, the individual is informed and invited to apply for repayment. This is not the case with Class 4, as no records are kept. Any overpaid Class 4, other than liabilities that are reduced as a result of an amendment to a tax return, must be reclaimed on the appropriate form (CF28E). It is therefore much better to apply for exception or deferment where possible.

Disputes and appeals

The appeals procedure for NICs is largely the same as that for dealing with income tax disputes.

- Where agreement cannot be reached, a senior officer of the Board of HMRC will make a formal decision.
- This decision is appealable to the First Tier Tax Tribunal in writing within 30 days, although the Tribunal has discretion to admit late appeals.
- The appellant can ask HMRC to carry out a formal review of a decision before the appeal is notified to the Tribunal.
- Either party may express dissatisfaction with a First Tier Tribunal decision.
- An appeal may then go through the Upper Tribunal, Court of Appeal and eventually to the House of Lords.

Couples

Class 2 and Class 4 NICs are calculated separately for husbands and wives, and for civil partners. Their NICs are not affected by each other's profits or losses.

Furnished holiday lettings

Under special tax rules, income from certain holiday lettings is taxed as if it were trading income. Class 2 NICs might be due, depending on the amount of time spent on the business. The normal rules concerning limits and annual maximum contributions apply. No Class 4 NICs are charged on this particular type of income. Property letting is generally not treated as self-employed trading. The furnished holiday lettings tax rules will end on 5 April 2010.

Conclusion

- For self-employed earners, and the people for whom they provide services, it is very important to ensure that employment status is determined correctly.
- The self-employment category is attractive because NICs are much lower than for employees and their employers: but the consequences of mistakes can be serious, and professional advice must always be taken in doubtful cases.
- Self-employed people should recognise that their entitlement to some state benefits is lower than for employees and should consider making their own private arrangements.
- The need to consider Class 2 NICs when a business is started is sometimes overlooked.
- Although there is a combined notification process for income tax and Class 2 NICs, the NIC time limit is earlier.
- There are some circumstances in which Class 2 NICs do not need to be paid, but this should be agreed with the NICO in advance.
- Late notification can result in a penalty.

- Class 4 NICs do not count towards any state benefits, so it is important to ensure that they are not paid unnecessarily.
- The NICO's main administrative function and several of its specialist offices, including those dealing with deferment applications, are at the following address:

National Insurance Contributions Office

Benton Park View

Newcastle upon Tyne

NE98 1ZZ

Telephone: 0845 302 1479.

This guide is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking action on the basis of the contents of this publication. The guide represents our understanding of the law and HM Revenue & Customs practice as at September 2009, which are subject to change.