**National Insurance Contributions – The Basics**

Welcome to this first in a mini series of podcasts on National Insurance Contributions, or NICs.

To begin with, I will look at the basics of NICs, which after all is in the news at the moment because of the budget proposals to merge Income Tax and National Insurance Contributions. Although I consider that to be a long way off, in fact I doubt that it will ever happen, it is an important point. One of the most important points to remember is that Pay As You Earn Income Tax is based on a system of cumulative deductions, whereas National Insurance Contributions are deducted non-cumulatively, in accordance with earnings periods that we will look at.

So the rules for payment and deduction from NICs do differ somewhat from the rules for deduction and payment of PAYE income tax, although, over a period of time, there has been some realignment to bring the rules closer together. In this series of NIC podcasts, I will explain the main differences and in the other podcasts I will look at some of the more complex issues. But perhaps I should tell you that on the 1st December I will be covering the issues of NICs in more detail at the AAT CPD Mastercourse in London and of course there I will be to answer your questions.

NICs are potentially payable by employees who are aged between 16 years and the state retirement age, which is currently 65 for men, but has already started to rise from age 60 for women. That point I’ll also come back to. NICs are payable by employers as well and by the self-employed and the amount payable is subject to certain conditions and limits, all of which we will look at in the podcast. But let me first remind you of the different classes of NICs that exist.

The classes of NICs that are potentially payable in the UK are as follows. Firstly Class 1 NICs, payable on earnings related basis by employees and by their employer. Employees pay primary Class 1 NICs, where the standard rate is currently 12% and paid up to the upper earnings limit, and over and above the upper earnings limit employees pay 2% on their earnings. Employers however have to pay secondary Class 1 National Insurance Contributions on the same earnings, but they have to pay 13.8% with no upper limit. Next we have Class 1A National Insurance Contributions, which are only payable by employers and are currently charged at 13.8% on any taxable expenses payments and benefits in kind that are reported in the brown boxes on Form P11D. Class 1B National Insurance Contributions are payable by employers and are charged on taxable expense payments and benefits in kind that are included in a PAYE Settlement Agreement. Then we have Class 2 National Insurance Contributions which are paid by the self-employed earners at a flat rate, that is currently £2.50 per week and it can also be paid voluntarily by someone who is not liable to Class 1 National Insurance Contributions, but wants to protect their State Pension and their benefit entitlement. Next we have Class 3 National Insurance Contributions which are voluntary contributions that may be paid by UK nationals who go overseas and leave the UK NIC system, this will be paid to protect their State Pension and benefit entitlement. Finally we have Class 4 National Insurance Contributions which are paid by the self-employed and are profit related contributions. These are charged at 9% on profits between £7,225 and £42,775, then the self-employed pay 2% on any earnings above that upper profits limit.

Section Two, let me look at Class 1 NICs in more detail

As I have already said, Class 1 primary National Insurance Contributions are payable by employees aged between 16 and the state pension age, and Class 1 secondary NICs are payable by the employer. But both are with the proviso that the employee’s earnings are at least equal to the earnings threshold. The earnings threshold is currently £139 per week or £602 per month for employee’s primary NICs, and there is a lower figure of £136 per week or £589 per month for the employer’s secondary threshold. The different secondary threshold is new this year. Let me give you an example. An employee paid say £600 in December would pay no Class 1 National Insurance Contributions because it is below the £602 monthly earnings threshold. But, the employer would pay NICs of 13.8% on the excess over the monthly secondary threshold which is £589; the employer would therefore pay £1.52 secondary Class 1 NICs, when the employee is paying nothing.

The rate of Class 1 NICs is determined by the category letter to be applied to the employee’s particular circumstances. Many of you may think of this in terms of Table A etc.

The most common category letter that you will encounter is in fact Category A for non-contracted out earnings, which then applies the standard rate of 12% for primary employee contributions and 13.8% for secondary employer contributions. Remember that for employees there is an upper earnings limit of £817 per week or £3,540 per month and earnings in excess of those limits will only attract 2% Class 1 NICs for the employees. In contrast, the employer, where there is no upper earnings limit must pay 13.8% on all of the earnings above the secondary earnings threshold. So another example, an employee paid £4,000 in December would pay 12% Class 1 NICs on the earnings between the primary threshold of £602 and the upper earnings limit of £3,540, which would be paying £352.56 on that element, but then would only pay 2% on the balance of the £460 earnings above the upper earnings limit, therefore paying another £9.20, giving us a total of £361.76 payable by the employee. The employer, however, will pay 13.8% on the salary of £4,000, less the secondary earnings threshold of £589, ie. 13.8% of £3,411, which is £470.71. If you want to check my calculations, you can use the online NICs calculator on the HMRC website.

The next category letter to consider is Category B, which relates to the married woman’s and widow’s reduced rate of 5.85%. Historically, when married women didn’t work as often as they do now and widows the same, they were offered the opportunity to pay a reduced rate of contribution because they wouldn’t get the same benefits when they reached state pension age. The number of employees who are currently entitled to pay reduced rate contributions is very limited, and it continues to reduce. But the point to note here is that employers should check annually that the woman employee who is on Category B reduced rate is still entitled to pay that reduced rate. If, for example, they were to be divorced in the year and not told their employer, they would have lost their right to pay the reduced rate. I always tell AAT members that, as an end of year check, it’s important that the employer asks such women to confirm in writing whether or not they still have an entitlement to the reduced rate. Failure to do that may result in the employer paying the under deduction.

The next category I want to consider is Category C, which relates to employees that are over the state pension age, and therefore do not have to pay Class 1 National Insurance Contributions on their earnings. It is important to remember that this does not affect the employer’s secondary contributions, which must be deducted at the standard rate, even if the employer operates the contracted out scheme. Again, let me make that clear. If there’s a contracted out scheme it will reduce contributions normally payable when the employee reaches state pension age, the employer contribution reverts to the standard rate of 13.8% and the employee would pay nothing at all. If I use my earlier example of an employee earning £4,000 in the month, the employee who is then over state pension age and on Category C will pay no Class 1 NIC Contributions, but the employer must still pay £470.71, that is 13.8% of the amount of £4,000 less the secondary threshold of £589. Again, an important point to note here is that the employer needs the CA4140 Age Exception Certificate as evidence that primary Class 1 NICs are not due. These certificates should be issued shortly before an employee reaches state pension age. Employers can obtain a certificate by telephoning the National Insurance Enquiries Helpline for Individuals, and that telephone number is 0845 302 1479. Employers could use Category C in the absence of a certificate, if the employee provides evidence of their age in the form of a Birth Certificate, but I would advise the employer to contact HMRC to obtain the CA4140 Certificate. Again this is an end of year check that I always recommend to AAT members for their employers or their employer’s clients.

Next, we’ve got Category J, which relates to employees or directors with more than one job, where a claim can be made to defer payment of standard rate NICs on the one payroll, paying only 2% and avoiding an overpayment. I will look at how to apply for deferment in another podcast.

Categories D, E, F, G, L and S relate to contracted, salary related or money purchase pension schemes and there are some other category letters related to mariners, which I will not look at.

Another category letter that needs careful consideration is Category X, which means that there is no liability for either the employee or the employer. Category X should be used as a default if there are no earnings at or above the lower earnings limit. In fact, I find that a lot of software will automatically default to Category X, if there were no earnings above the lower earnings limit and therefore no NICs paid. Category X should be used for a pension payroll, for earnings to employees under the age of 16 and where earnings do not reach the lower earnings limit. It should also be used where employees are seconded from abroad and have no Class 1 NIC liability for the first fifty two weeks in the UK or perhaps for a longer period if they have a certificate of coverage from the country that they have come from. One of the differences between PAYE Income Tax and Class 1 NICs is that HMRC issues a tax code number to employers to effectively tell the employer what Income Tax should be deducted, but no such notice is issued by the UK authorities for Class 1 NICs. It is important, therefore, that an employer has the appropriate evidence to support any non-standard category letter which is in use. So, for example, the CA4140 Age Exception Certificate should be available as evidence that the primary Class 1 NICs are not due from an employee over state pension age.

My advice to my AAT members, their employers and clients, as regards the use of Category X is that you must retain the appropriate evidence to justify that use. This might be a copy of the Birth Certificate of the young employee who is under 16, or the certificate of coverage A101 or E101 for a worker from the EU or EEA, or a similar certificate of coverage from a reciprocal agreement country like the USA. An employee seconded from a non-agreement company like India or China will have no certificate of coverage, but evidence will still be required of the assignment and the dates of arrival in the UK to justify the use of Category X for the first fifty two weeks.

Section Three, Class 1A National Insurance Contributions

Class 1A NICs are payable by employers who provide their directors and or employees with tax or benefits in kind, such as company cars and fuel, medical insurance etc. These are reported on the brown boxes on the annual return form P11D. The amount of Class 1A NICs due should be the total of the amounts reported in the brown boxes, multiplied by the Class 1A NICs percentage rate, which is now 13.8%. For the 2010/11 P11Ds it was 12.8%. HMRC guidance tells us that the following conditions must apply for Class 1A contributions to be payable:

First the employer and employed earners must satisfy the residence and presence conditions in Great Britain. The employment from which the benefit in kind is derived must be employed earners employment liable to Income Tax under the Income Tax Earnings and Pensions Act 2003 on an amount of general earnings. The benefit must be provided to an employee who is earning at a rate of £8,500 per annum or more per year, or to a Companies Act director. The benefit must not already attract a Class 1 National Insurance Contribution liability. We’re then told that employers do not have to pay Class 1A NICs on benefits that are firstly exempt from Income Tax, are taxable but specifically exempted from Class 1A National Insurance Contributions liability, are covered by a dispensation, are included in a PAYE Settlement Agreement, are returned on form P9D, which applies to employees earning at a rate of less than £8,500 per annum, are already liable for Class 1 NICs or benefits that are provided exclusively for business use, or for certain benefits, the private use of which is insignificant.

The amount of Class 1As calculated on the taxable benefits must be declared on the Annual Statutory Return Form, P11D(b), and of course we must be warned that a penalty will be charged if the P11D(b) is not received by HMRC by the 19th July following the end of the tax year. So, for example, 19th July 2012 for the current year 2011/12. If an employer checks the box on the P35 to confirm that no P11D(b) is due, they would not have to submit the form, although I’ve always advised AAT members that if HMRC issues a P11D(b) to an employer I would mark it nil if appropriate and send it back.

Class 1A NI Contributions should be paid by the 19th July, following the end of the tax year, subject to the additional three days to the 22nd July for electronic payment. And again be warned that interest will be charged on payments made after that statutory date. HMRC sends out payslips, normally in the first week of April, and these should be used to make payment to the Accounts Office at Shipley or Cumbernauld, unless payment is made electronically.

Section Four, Class 1B NICs

Employers have to pay Class 1B National Insurance Contributions in respect of the taxable expense payments and benefits in kind that they include in a PAYE Settlement Agreement, a PSA, and AAT members will be able to listen through the PSA podcast separately if they want more information on them. Class 1B NICs is also payable on the grossed up Income Tax payable by the employer and included in the PSA. So an example, if an employer provides a benefit of £1,000 and would then pay the grossed up tax due of £250, which is made up of £1,000 at the basic rate, 20%, in other words £200 and then grossed up at 100/80 it becomes £250 tax. So Class 1B NICs at 13.8% for the current tax year would be due on the £1,000 benefit, that is £138, and then Class 1B NICs again at 13.8% for the current year would be due on the tax paid of £250 and that would be £34.50. So the total Class 1B NICs charged would be £172.50 and the total cost of that £1,000 benefit including the tax charge of £250 would be £422.50, plus the £1,000 cost of the benefit.

The Class 1B NICs liability and the Income Tax liability due under the PSA must be paid by the employer by the 19th October after the end of the tax year, extended normally to the 22nd October, where paid by an acceptable electronic payment method. Although this year the 22nd October 2011 is a Saturday, which pushes the final payment deadline back to the last working day of Friday 21st October 2011. We always need to be aware of that issue with electronic payments.

Section Five, Class 2 and Class 4 NICs for the self-employed

Anyone that is self-employed has to pay Class 2 and Class 4 NICs, providing their self-employed earnings reach a certain level. The Class 2 NIC rates are currently a flat rate of £2.50 per week, plus the self-employed will pay Class 4 NICs as a percentage of the annual taxable profits and this is 9% on profits between £7,225 and £42,475 then paying 2% on profits over that amount of £42,475. If a self-employed person’s profits are expected to be less than £5,315 they may not have to pay Class 2 National Insurance Contributions and will be able to seek deferment.

Since April 2011, Class 2 NIC payments are due on the 31st January and the 31st July, which is the same as the self-assessment Income Tax bill. Class 2 National Insurance Contributions are payable either monthly or six-monthly by direct debit, whereas Class 4 National Insurance Contributions are paid with the Income Tax liability. Exception from liability for Class 4 contributions will be granted to anyone who, at the beginning of the year of assessment, is over pensionable age or anyone who, at the beginning of the year of assessment, is under the age of 16 and applies for exception or anyone who is non-resident for tax purposes.

Section Six, Class 3 National Insurance Contributions

Class 3 NICs are voluntary contributions that someone may decide to pay to protect their entitlement to the state pension and other state benefits. But someone who is self-employed or living abroad may be able to pay Class 2 contributions voluntarily instead and of course the Class 2 rate is much lower. Someone might choose to pay voluntary NICs if they are unemployed and not claiming benefits, if they’re employed but not earning enough to pay NICs and doesn’t get National Insurance credits, if they’re self-employed and have a Certificate of Small Earnings Exception that means that they don’t have to pay Class 2 NICs, if they’re a married woman or widow who cancels her reduced rate election partway through a tax year and also, as I’ve already said, if they’re living abroad they may pay Class 3 contributions. HMRC guidance tells us that they are some circumstances when someone will not be able to pay Class 3 voluntary, the most usual ones are a married woman or a widow who chose to pay reduced rate NICs for the whole tax year, but which they want to pay Class 3, someone who reached state pension age in the tax year for which they want to pay Class 3 or someone entitled to National Insurance credits, but apparently there are some exceptions to this.

Voluntary National Insurance Contributions for the current year 2011/12 are £12.60 a week for Class 3 contributions or £2.50 a week for Class 2 contributions. In deciding whether to pay voluntary contributions and whether to pay Class 2 NICs or Class 3 NICs, let’s consider what benefits are covered by these contributions.

If you look on the HMRC website, you’ll see a table of National Insurance Contribution Classes, and what they pay for. If I first of all look at Class 1 paid by employees, benefits covered include State Pension, additional State Pension, Contribution Based Jobseekers Allowance, Contribution Based Employment and Support Allowance, Maternity Allowance and Bereavement Benefits.

In contrast, Class 2 contributions paid by the self-employed covers basic State Pension but doesn’t include additional State Pension and doesn’t include Contribution Based Jobseekers Allowance, except for share fishermen and volunteer development workers employed abroad, and I doubt that any of us will see many of them. The Class 2 contributions does cover Contribution Based Employment and Support Allowance, it does cover Maternity Allowance and it does cover Bereavement Benefits.

Now when we look at the cover provided by Class 3 voluntary contributions we find that it does cover the basic State Pension, which is the reason why most people pay it, it doesn’t cover the additional State Pension, it doesn’t cover Contribution Based Jobseekers Allowance, it doesn’t cover Contribution Based Employment and Support Allowance and it doesn’t cover Maternity Allowance. But it does cover Bereavement Benefits. So, as I often tell my audiences on the Global Payroll Course, it’s clearly Class 2 is a cheaper amount to pay and provides better coverage.

Well then, Class 4 National Insurance Contributions paid by some self-employed people don’t count towards any state benefits. Class 1A and Class 1B contributions paid by employers only also don’t count towards any state benefits. So that gives us a picture of what contributions do provide cover for State Pension, or other benefits.

Section Seven, Summary

Well for now that’s some of the basics of National Insurance Contributions, but of course there is a lot more to cover and I hope to do that in more podcasts, as well as on the CPD Mastercourse in London on the 1st December 2011. So for now, thanks for listening to this podcast.