CHAPTER 23

CLASS 1 NATIONAL INSURANCE CONTRIBUTIONS

23.1 Introduction

NIC is a very important money-raising tool for the Treasury and, year on year, National Insurance Contributions bring in around 22% of total Government revenue. Collection of NIC is administered by the National Insurance Contributions Office (NICO) which is now part of the HM Revenue and Customs. Other parts of the HMRC assist NICO in the collection of National Insurance Contributions, particularly via the PAYE system.

The purpose of National Insurance Contributions is to provide certain retirement benefits such as the State Pension, as well as to fund certain Social Security benefits such as Job Seekers Allowance and Employment and Support Allowance. If the amount raised by NICO by way of National Insurance Contributions is insufficient to cover these benefits, any deficit is made up by a grant from the Treasury.

At present there are six classes of National Insurance:

a) Class 1 - paid by both employees and employers on earnings from employment. SSCBA 1992, s. 1

b) Class 1A - paid by employers only on benefits awarded to certain employees.

c) Class 1B - paid by employers only on Pay As You Earn Settlement Agreements (PSAs).

d) Class 2 - paid by self-employed persons on the profits from their trade.

e) Class 3 - voluntary contributions paid by taxpayers who wish to top-up their contribution record in order to preserve their entitlement to State benefits.

f) Class 4 - paid by self-employed persons on the profits from their trade. Classes 2 and 4 will be covered in the business tax section of your course.

This gives us an overview of National Insurance. In this chapter we shall concentrate solely on Class 1 NIC.

23.2 Class 1 NIC

Class 1 National Insurance Contributions are broken down into **primary** contributions or **secondary** contributions. **Primary** contributions are paid by **employees** whilst **secondary** contributions are paid by **employers**.

Class 1 NICs are paid on earnings from the employment. If an employee receives earnings, that employee will pay Class 1 primary contributions whilst if an employer pays earnings to an employee, the employer makes a secondary Class 1 contribution.

Both primary and secondary contributions are accounted for under the PAYE system and are paid over to HMRC, along with income tax, on the **19th of each month.**

Every time an employer makes a payment of earnings to an employee, that employer will have to account for Class 1 secondary NICs currently at a rate of 12.8%. This is a very substantial additional cost borne by employers and the majority of NICs raised by the Treasury are collected from employers rather than employees.

23.3 Earnings

SSCBA 1992, s. 3

Class 1 contributions are paid on "earnings". It is very important that we establish what constitutes **"earnings"** for National Insurance purposes. **Any cash payment** made by an employer to an employee is likely to be earnings for NIC purposes. This will include salaries and bonuses, but does not include the taxable element of termination payments taxed under s.401 ITEPA 2003. It will not include the reimbursement of genuine business expenses.

If an **employer settles an employee's personal liability**, this payment will also constitute earnings for Class 1 National Insurance. For example, if an employee makes a visit to a shop and spends £100 which is not a business expense and that £100 is subsequently paid by the employer, the employer has paid for an employee's personal bill. That payment will constitute earnings for NIC (but not PAYE). As such, the £100 will be charged to Class 1 National Insurance. Of course, if the employee paid the bill and was subsequently reimbursed by the employer, the amount reimbursed would also be subject to Class 1 NIC and PAYE. If the supply of the goods was arranged by the employer directly with the supplier, the Class 1 NIC is not due on the payment but Class 1A will be due from the employer.

If an employer makes a non-cash payment to an employee – i.e. some form of payment in kind – and that **payment in kind** can be **surrendered for cash**, that payment will **also be earnings** for NIC purposes, just as it is for PAYE purposes.

Payments in the form of "**readily convertible assets"** are earnings for NIC purposes. You will recall from the PAYE chapter, that a readily convertible asset is an asset that is traded on a recognised Stock, or Commodities Exchange, or an asset for which trading arrangements exist. The definition of a readily convertible asset for NIC is exactly the same as the definition we looked at for PAYE. The readily convertible assets legislation was put in relatively recently as many employers had introduced imaginative NIC avoidance schemes to reduce their NIC liabilities.

ITEPA 2003, s. 702

Vouchers are earnings for NIC, regardless of whether they are cash or non-cash vouchers. Childcare vouchers given to employees are specifically excluded to the extent that they do not exceed £55 per week and are not earnings for Class 1 NIC. Class 1 NIC is charged on any excess amount over the £55 limit.

Mileage payments are not earnings for Class 1 NIC purposes if they do not exceed 40p per mile (irrespective of the number of miles reimbursed). If an employer pays more than this then the excess over 40p per mile will be subject to Class 1 NIC.

So, if an employee travels 15,000 miles on company business in a year and is reimbursed 45p per mile, the excess of 5p per mile i.e. £750 will be subject to Class 1 NIC. Remember that the excess reimbursement for tax purposes will not be subject to PAYE.

The vast majority of common benefits will not be earnings for Class 1 NIC purposes. For instance, if an employee is given use of a company car, or has a taxable cheap loan, that benefit will be charged to income tax, but it will not then be charged to Class 1 National Insurance Contributions in the hands of the employee. Again, Class 1A will be payable by the employer. We will look at Class 1A in a later chapter.

23.4 Class 1 Primary contributions

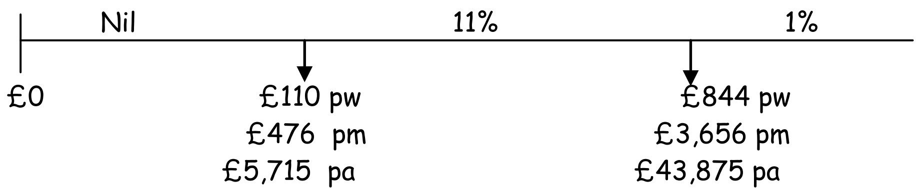
Primary contributions are paid by employees on earnings in an "earnings period". Most UK employees have a monthly earnings period – i.e. we receive our salary etc on a monthly basis. Some employees, typically in manufacturing industries, still receive their earnings weekly.

The current rates of National Insurance are given in the tax tables. For employees who receive their remuneration **weekly**, **no National Insurance is charged on the first £110 per week** of an employee's earnings. This is called the "earnings threshold" (ET). On **earnings between £110 per week and £844 per week,** the main rate of Class 1 NIC is **11%.** The weekly limit of £844 is called the "upper earnings limit" (UEL).

Employees also pay Class 1 NICs at the additional rate of **1% on earnings in excess of the upper earnings limit i.e. above £844** per week.

The tables also give us the monthly and annual limits. For employees with a **monthly earnings period,** for earnings up to £476 per month, NIC is charged at zero percent. For earnings between £476 and £3,656 per month, the rate is 11% SSCBA 1992, s.8
and there is a further NIC liability of 1% on earnings in excess of £3,656 per month.

This is illustrated by the diagram below:



An employee will start to pay Class 1 primary contributions with effect from his 16th birthday and will stop paying NIC at the date of retirement, which for a man is currently 65. For women born before 6 April 1950, the retirement age is 60. For women born after 6 April 1950, the retirement age is increasing to 65 between 2010 and 2020. Between these dates, retirement age for a woman born on or after 6 April 1950 will depend on her exact date of birth. SSCBA 1992, s.6

NICs are calculated for earnings periods. An employee who is paid monthly will have 12 earnings periods in any particular tax year, so to calculate his NIC for the year, we do 12 separate NIC calculations and add them together.

Illustration 1

An employee has a salary of £18,000 per annum in 2010/11 which is paid monthly. The employee has use of a company car giving rise to a benefit of £2,500. The employee gets a cash bonus at Christmas of £5,000.

The salary and the Christmas bonus constitute earnings for Class 1 NIC, but the company car benefit does not.

The monthly limits are:

Earnings threshold:	£476
Upper earnings limit:	£3,656

For 11 months of the year his earnings will be 18,000/12 = £1,500.
In December his earnings will be 1,500 + 5,000 = £6,500.

The calculation will therefore be as follows:

	£
Class 1 primary NIC	
11 months with earnings of £1,500	
£(1,500 – 476) x 11% x 11 months	1,239
1 month with earnings of £6,500	
£(3,656 – 476) x 11% x 1 month	350
£(6,500 – 3,656) x 1% x 1 month	28
NIC payable	**£1,617**

The effect of this is that part of the £5,000 bonus paid in December 2010, will only have been charged to NIC at 1%.

23.5 Directors

The above rules do not apply to directors. **All directors** have an **annual earnings period**. This means to calculate a director's NIC we look at their earnings in the whole of the tax year, irrespective of whether the director was paid on a weekly or monthly basis. This is to prevent a company director from manipulating the NIC rules by paying himself in such a way as to minimise his NIC for the year.

Illustration 2

Take the figures in the previous illustration, but this time assume that the salary, the car benefit and the Christmas bonus are accruing to a director rather than a normal employee.

To calculate the director's NIC we need to aggregate his earnings for the whole of the tax year and compare to the annual limits.

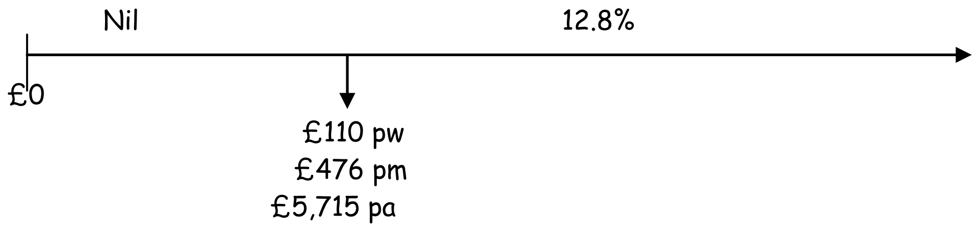
Annual earnings
£(18,000 + 5,000) = £23,000

Class 1 primary NIC
£(23,000 – 5,715) @ 11% **£1,901**

We see here that, unlike as with the employee in the previous illustration, none of the director's earnings will attract the 1% rate of NICs and for this reason it tends to be more expensive from an NIC perspective to be a director rather than a normal employee.

23.6 Class 1 Secondary contributions

Class 1 secondary contributions are paid by employers on any earnings paid to employees. The current rate of Class 1 secondary contributions is zero percent on earnings up to the earnings threshold and 12.8% on the excess. The weekly, monthly and annual earnings thresholds are the same for employers as they are for employees. SSCBA 1992, s.9



You will also note two things here. The first is that the **rate of NIC is higher for employers than for employees – i.e. 12.8% as opposed to 11%.** The second thing to note is that there is **no upper earnings limit** for employer's contributions, i.e. the 1% rate does not apply for employers. So for every one pound of earnings paid to an employee above the earnings threshold, the employer will have to pay 12.8 pence in National Insurance Contributions.

This is a substantial cost for employers to have to bear and effectively, adds nearly another 12.8% to their total wages bill.

In the case of an employee or director earning £23,000 per year, the secondary liability to be paid by the employer is:

£(23,000 – 5,715) @ 12.8% = £2,212

Employer secondary contributions begin with effect from the employee's 16th birthday, but there is no upper age limit. So if a salary is paid to an employee who is 68 years old, the employee will have no Class 1 primary liability, but the employer will still have to pay Class 1 secondary contributions at 12.8%.

Class 1 secondary NIC contributions paid by the employer in respect of an employee, along with Class 1A and 1B contributions, are deductible by the employer in arriving at taxable profits.

23.7 Regional Class 1 NIC Holiday

On 22 June 2010, the Government announced its intention to introduce **a regional Class 1 NIC 'holiday' for new businesses**. It is anticipated that the scheme will start in September 2010 but any new business set up from 22 June which meets the necessary conditions will be able to take advantage of the relief. At the time of writing, full details of the operation of the scheme have not been published.

The scheme will apply to new businesses set up in Scotland, Wales and Northern Ireland. It will apply to businesses set up in England, apart from London, the South East and the East. The aim is to help new businesses in areas of the UK that most require assistance. The scheme will end after three years.

Under the scheme, an employer will not be required to pay secondary Class 1 NIC for **the first 52 weeks** of an employee's employment, where the employee is taken on by the employer **in the first year of business**. The relief applies in respect of the **first 10 employees hired**, but is capped at **a maximum of £5,000 per employee**. Once the £5,000 limit has been reached for an employee, secondary Class 1 NICs will have to be paid as normal.

Where a new business commences from 22 June 2010 but prior to the actual introduction of the scheme, secondary Class 1 NIC will continue to be paid as normal. However, once the scheme starts, the employer will receive full relief.

The relief will not be available in respect of employees engaged via personal or managed service companies.

Remember that primary Class 1 NICs payable by the employee will continue to be paid in full as normal.

23.8 State Second Pension

When we calculated the employee's Class 1 NIC liability in the previous illustrations, we did so on the assumption that the employee had not "contracted out" of the State Second Pension.

The State Second Pension provides individuals with an Additional State Pension. The amount of the pension relates to the earnings of the employee, but is more generous for the low paid.

It is possible for an **employee to contract out of the State Second Pension** and if he does so, he is informing the Government that he will make his own pension arrangements. There are certain advantages from an NIC point of view of contracting out of the State Second Pension.

If an employee is contracted out of the State Second Pension and is a member of an occupational pension scheme with his employer, that employee will get a 1.6% rebate on his National Insurance Contributions.

The employee will pay Class 1 NIC at a reduced rate of 9.4% on earnings between the earnings threshold and the upper accruals point. Earnings between the upper accruals point and the upper earnings limit will remain liable to NIC at 11%. Earnings in excess of the upper earnings limit are subject to NIC at the 1% rate.

In addition, a rebate of 1.6% is given on earnings between the lower earnings limit and the earnings threshold. This is deducted from the total NIC liability.

If an employee contracts out of the State Second Pension and has a personal pension, the employee will continue to pay NIC at the **normal rate of 11%, but** the National Insurance Contributions Office will **then take the rebated amount of 1.6%** and **redirect it into the employee's personal pension scheme.** The employer will also continue to pay NIC at the normal rate of which part will be paid into the employee's pension scheme.

Where an employer operates a salary related occupational pension scheme which is contracted out, employer's secondary contributions between the earnings threshold and the upper accruals point will be 9.1% as opposed to 12.8%. A 3.7% rebate is given on earnings between the lower earnings limit and the earnings threshold.

If the occupational scheme is a money purchase scheme, the employer contributions will be at a rate of 11.4% on earnings between the earnings threshold and the upper accruals point. The rate of the rebate on earnings between the lower earnings limit and the earnings threshold is 1.4%

Remember that, for examination purposes, all the limits and rates are clearly set out in the tax tables!

It is intended that from 6 April 2012, it will only be possible for salary related occupational pension schemes to be contracted out.

23.9 Overseas aspects

Persons (individuals or companies) are not required to pay Class 1 NICs unless they are "resident or present" in Great Britain. SSCBA 1992, s. 1(6)

Great Britain means England, Scotland and Wales (i.e. not Northern Ireland) although the detailed regulations in SI 2001/1004 (paragraph 145 onwards) do extend these provisions to Northern Ireland. For the rest of this session, we shall use the term "UK".

Class 1 primary contributions are payable by employees who are either

- **resident**, or
- **present**, or
- **ordinarily resident**

in the UK.

Secondary contributions are payable by employers who are resident or present in the UK when contributions become payable, or who have a place of business in the UK at that point.

"Residence" and "ordinary residence" are not separately defined for NIC and will therefore take the meaning as outlined in HMRC's booklet HMRC6 (i.e. as for income tax). The term "present" is similarly undefined, but has a looser interpretation than formal "residence". Any questions as to whether an employed earner is "present" in the UK will be dealt with on a case by case basis.

For employees coming to the UK or leaving the UK, the Class 1 NIC position can be complex and depends largely on where the employee is going to or coming from. Different rules apply depending on whether the employee is coming from or going to a country in the European Economic Area (including Switzerland), or a country with which the UK has a Social security Agreement, or a country outside the EEA with which there is no social security agreement.

(i) Leaving the UK

If the employee is going to work in an EEA country for a period which is not expected to exceed 24 months, both the employee and the employer will generally continue to pay UK national insurance contributions. After 24 months (or immediately in any other case) the employee will pay social security contributions in the EEA country and UK NICs will not be paid.

If the employee is going to work in a country with which the UK has a reciprocal agreement, the employee and employer will continue to pay Class 1 NIC where the period of overseas employment will not exceed the maximum period under the terms of the agreement. For example, the UK has reciprocal agreements with the USA and Canada, whereby UK NIC will continue to be paid for postings of up to 5 years.

If an employee leaves the UK to take up employment abroad outside the EEA in a country with which there is no social security agreement, liability to pay Class 1 NICs can **continue for a period of 52 weeks** from the date of departure. Class 1 secondary liabilities will also continue.

This **"52 week NIC extension"** will only apply if SI 2001/1004 para 146

- the employer has a place of business in the UK; and
- the employee is ordinarily resident in the UK; and
- immediately prior to commencing employment abroad the employee was resident in the UK.

Therefore, the 52 week NIC extension will typically apply to employees working overseas for short periods. If an employee leaves the UK to take up permanent employment abroad, he would be treated as not ordinarily resident and liability to pay Class 1 NIC would cease at the date the UK employment ceased.

Any employee not paying Class 1 NICs is entitled to make **voluntary Class 3 contributions in order to preserve entitlements to state benefits** etc.

(ii) *Coming to the UK* SI 2001/1004 para 145(2)

Where an employed earner comes to the UK, from an EEA country for a period of not more than 24 months, no Class 1 NICs will be payable. After 24 months (or immediately in any other case) Class 1 NICs will be due.

If the employee comes to the UK from a country with which the UK has a reciprocal agreement, Class 1 NICs (primary and secondary) will either **commence from the date of arrival, or** the employee will **continue to pay contributions in the home country**. The treatment depends on how long the employee is staying in the UK and on the terms of the reciprocal agreement.

If the employee comes to the UK from a country with which the UK has no reciprocal agreement, providing that

- the employee is not ordinarily resident in the UK; and
- the employment is mainly outside the UK with an employer whose place of business is outside the UK;

no Class 1 NICs are payable for 52 weeks following the employee's arrival.

This **"52 week NIC holiday"** would most commonly apply to employee's working temporarily in the UK for an overseas employer.

After 52 weeks, Class 1 primary and secondary contributions will become payable in the usual way.

23.10 NIC administration

NICs are dealt with on a day to day basis by the **National Insurance Contributions Office (NICO)**.

The collection and payment of Class 1 NICs is the responsibility of the employer under the PAYE regulations. If an employer fails to comply with the regulations, notices under Sch 4 SI 2001/1004 can be issued to recover any NICs underpaid. SI 2001/1004 Reg 67

Class 1 NICs are due for payment along with income tax collected under PAYE. The payment, interest and late payment penalty provisions we looked at in Chapter 22 apply equally to NIC due, as well as tax. SSCBA 1992, Sch 4 Para 10

Details of Class 1 primary and secondary NICs payable must be included on the employer's end of year summary (form P35). Penalties for late or incorrect forms P35 were discussed in Chapter 22. **Penalties cannot be charged twice for tax and NIC failures in respect of the same form(s).**

Taxpayers have a right of appeal against any assessment of national insurance contributions. The NIC appeals procedure follows that for income tax.

Example 1

Which of the following forms of remuneration are earnings for Class 1 NIC purposes?

a) Interest free loan
b) £5,000 of premium bonds
c) £20,000 of gold bullion
d) John Lewis store voucher
e) Reimbursement of home telephone calls
f) Reimbursement of business expenses

Example 2

Harry is an employee earning £26,000 per year. He is paid weekly and in March 2011 he received a bonus of £1,000.

Calculate his Class 1 NIC due for 2010/11.

Answer 1

		Earnings?	
a)	Interest free loan	X	(No NICs on benefits)
b)	£5,000 of premium bonds	✓	(Surrendered for cash)
c)	£20,000 of gold bullion	✓	(Readily convertible asset)
d)	John Lewis store voucher	✓	
e)	Home telephone bill	✓	(Settlement of employee's liability)
f)	Reimbursed business expenses	X	

Answer 2

Earnings:
51 weeks @ £500
1 week @ £1,500

NIC:	£
£(500 – 110) @ 11% x 51	2,188
£(844 – 110) @ 11% x 1	81
£(1,500 – 844) @ 1% x 1	7
Total	**£2,276**