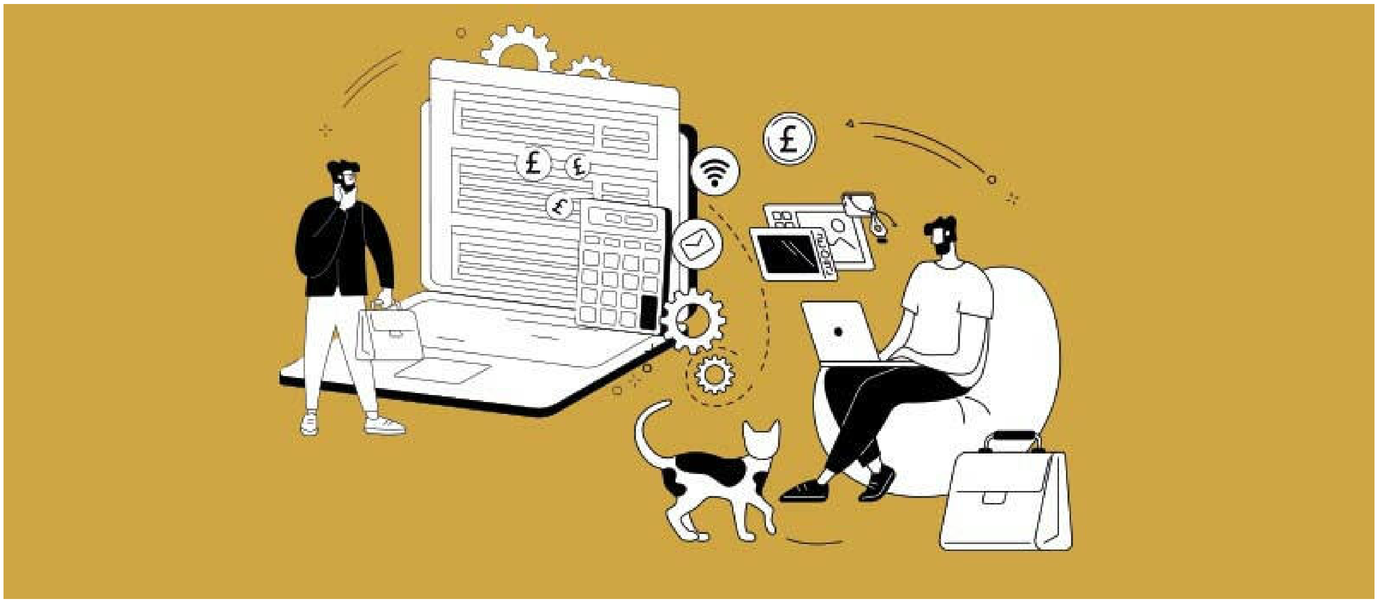
Changes to Class 2 NICs: the implications for traders with lower profits

OMB Personal tax



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We consider the 2022/23 changes that will apply to Class 2 National Insurance for self-employed individuals with lower profits and how to see through the practical implications that may arise.

Key Points

What is the issue?

From 2022/23, self-employed individuals with profits falling between the small profits threshold and lower profits limit benefit from Class 2 NICs ‘treated as paid’. Those with profits below the small profits threshold may need to make voluntary Class 2 NICs to secure a qualifying year.

What does it mean for me?

Traders may wish to understand whether they can bring their profit level over the small profit threshold.

What can I take away?

A trader's overall tax position should always be borne in mind, as should their potential access to NI credits already given under the benefits system.

It has been a busy year for changes to National Insurance contributions (NICs). Following Rishi Sunak's Spring Statement, in April 2022 we saw the rates of both Class 1 and Class 4 NICs increase by 1.25 percentage points as a precursor to the (now abandoned) Health and Social Care Levy. The rates were then brought back down again following Kwasi Kwarteng's September 2022 'Mini Budget' – one of the few measures not reversed by his replacement, Jeremy Hunt! For the self-employed paying Class 4 NICs on an annual basis, the rate has been set at an averaged 9.73%.

Planted in the middle of the rate changes, in July 2022 the National Insurance payment threshold for employed workers was increased to align with the personal allowance. For the self-employed, this change resulted in an annualised lower profits limit (the point at which both Class 4 and Class 2 NICs becomes payable) of £11,908 for the 2022/23 tax year, but this will follow the personal allowance from 2023/24 onwards.

With all of the above, it is easy to overlook a lesser discussed change that came out of the Spring Statement relating to Class 2 NICs for lower earning self-employed individuals. For these purposes, 'self-employed individuals' means sole traders and individual partners in partnerships. In the government's Spring Statement document, the measure was described as follows:

> 'The government is also taking steps to ensure that self-employed individuals with lower earnings fully benefit. Spring Statement announces that from April 2022 self-employed individuals with profits between the small profits threshold and lower profits limit will continue to build up National Insurance credits but will not pay any Class 2 NICs.'

Class 2 NICs are important for the self-employed, as they are the determining factor for having a 'qualifying year' for state pension entitlement and contributory state benefits.

The effect of the Spring Statement changes for self-employed individuals is as follows:

- **Situation A:** Those with tax adjusted profits **over** the lower profits limit (£11,908 for the 2022/23 tax year and in line with the personal allowance in future years) will be required to pay Class 2 NICs as normal, at a rate of £3.15 per week.
- **Situation B:** Those with tax adjusted profits **below** the lower profits limit, but **more than** the small profits threshold (£6,725 for the 2022/23 tax year), will not be required to pay Class 2 NICs, but will be treated as having paid Class 2 NICs for the year. (We discuss below exactly what is meant by this.)
- **Situation C:** Those with tax adjusted profits **below** the small profits threshold will not be treated as having paid Class 2 NICs, so may need to pay voluntary Class 2 NICs (at the same rate of £3.15 per week) if they wish to maintain their entitlement to contributory state benefits.

Consequently, those with the very lowest profits (situation C above) will *potentially* need to pay voluntary Class 2 NICs if they are to secure a qualifying year for National Insurance purposes, whereas a person with slightly higher profits, up to £11,908 (situation B), will not need to pay anything to have a qualifying year.

So what could this mean in practice?

National insurance: ‘credits’ versus ‘treated as paid’

As noted above, the Spring Statement documents all referred to National Insurance ‘credits’. However, the National Insurance Contributions (Increase of Thresholds) Act 2022 s 3(2) sets out the intention that those with profits below the lower profits limit will be *treated as though they had paid* Class 2 NICs. This is actually quite different to receiving a National Insurance credit.

Note that the legislation referenced above merely provides that the Treasury *may* make provision that a person with profits under the lower profits limit is treated as having made Class 2 contributions, and that these regulations can apply with retrospective effect to no earlier than 6 April 2022. The regulations themselves have not yet appeared.

What are National Insurance credits?

There are two types of ‘National Insurance credits’: Class 1 NI credits and Class 3 NI credits. They are available in certain circumstances where people are not able to work or might only have a limited ability to work; and where they receive certain means-tested benefits (including working tax credit). The type of credit received will dictate the benefit that the recipients will obtain:

- Class 1 NI credits count towards state pension entitlement and some other state benefits.
- Class 3 NI credits count towards state pension entitlement only.
- A list of the different circumstances qualifying for each type of National Insurance credit is available on GOV.UK (see bit.ly/3TTmNNE).

What is National Insurance ‘treated as paid’?

The concept of National Insurance being ‘treated as paid’ was already in existence for Class 1 NICs. Employees earning over the lower earnings limit but beneath the primary threshold are treated as having paid Class 1 NICs without actually having to physically make a payment.

The concept now being introduced for Class 2 NICs purposes is broadly similar. However, it could be argued that the opportunity to fall inside or outside the band in which it applies (between the small profits threshold and the lower profits limit) depends on rather more subjective principles, since the calculation of taxable trading profit relies on certain decisions being made relating to allowable expenditure and tax adjustments.

It is worth pointing out here that chargeability to Class 2 NICs is aligned with the profits as chargeable to income tax under the Income Tax (Trading and Other Income) Act (ITTOIA) 2005 Part 2 Chapter 2.

How is profit calculated?

Consider an individual who has gross self-employed income in excess of the small profits threshold, but where after expenses and tax adjustments their net profit falls below the threshold. In this case, it can be easy to see that the trader might question whether it would be sensible not to claim all of their business expenses on the tax return. In doing this, the trader might be able to ‘engineer’ a higher profit figure for the purposes of the tax return and, by extension, qualify for Class 2 NICs treated as paid. But is this sort of profit engineering legitimate or permissible?

ITTOIA 2005 s 25 says that profits of a trade must be calculated in accordance with generally accepted accounting practice (UK GAAP).

Under UK GAAP, the accounts must be a true reflection of the financial performance of the business. Therefore, assuming that we are dealing with a trader who is not using cash accounting or the trading allowance, it seems that a trader cannot decide *not to declare* business expenses simply to inflate the taxable profit. So is there anything else to consider?

Review tax adjustments

It can be the case that tax adjustments for private use are carried forward each year with little consideration given as to whether the position might have changed. It might therefore be advisable, when a trader prepares their 2022/23 accounts, to give these adjustments some renewed attention to ensure they continue to be realistic and supportable.

Another thing to bear in mind is that traders do have a choice when it comes to capital allowances. Might the trader be better off disclaiming allowances?

Of course, care would need to be taken for any newly acquired plant and machinery, bearing in mind that if the annual investment allowance is not claimed in the year the expenditure is incurred, the trader will not be able to claim the 100% deduction in later years, and would only be entitled to less generous writing down allowances. This may or may not be in the trader's favour depending on the overall circumstances in both current and future tax years.

Alternative ways of calculating taxable profit

What other ways might there be to legitimately increase the profit figure on the self-assessment return? There are a few other options to consider:

- a possible switch to cash basis (or vice versa to accruals basis);
- the use of simplified expenses; and
- claiming the £1,000 trading allowance.

Use of the cash basis

Under the cash basis (see ITTOIA 2005 Chapter 3A Part 2), income and expenses are only recorded when actually paid and received. This could provide the trader with the opportunity to plan purchases or delay paying bills until just after the year end so that the expense falls into the following tax year.

In addition, a trader who uses the cash basis of accounting is restricted to £500 of allowable finance costs. This restriction to finance costs may prove beneficial to the trader if their actual finance costs are higher than this and they are hoping to legitimately increase their taxable profit for Class 2 NICs purposes.

Once a trader has elected to use the cash basis of accounting, then they must generally continue to do so unless they have a commercial reason to return to the accruals basis (or the level of their turnover exceeds the permitted turnover limits). There are also transitional rules that apply on entering the cash basis.

Use of simplified expenses

Simplified (or fixed rate) expenses (see ITTOIA 2005 Chapter 5A Part 2) mean that traders are able to make certain flat rate deductions for three key categories of business expense:

- motor vehicles;
- use of home for business purposes; and
- private use of business premises.

Using these could be of use to a trader whose actual expenses exceed the flat rates allowable under the simplified method. As a reminder, simplified expenses cannot be used for motoring expenses if capital allowances have already been claimed in respect of a particular vehicle. Further, if simplified expenses are used in respect of a particular vehicle, then the trader must stick with that approach for the duration of that vehicle’s use in the business.

Use of the trading allowance

Another way that a lower income trader might legitimately create a higher taxable profit figure is by making use of the trading allowance (see ITTOIA 2005 Chapter 1 Part 6A).

This might be an option where the allowable expenses and tax adjustments are more than £1,000. By claiming partial relief of the trading allowance, the trader is only allowed a flat deduction of £1,000 against their gross trading income, meaning a higher taxable profit where their actual expenses are greater than this.

The bigger picture

Of course, when thinking about any of the above methods to increase the trader's profit so that it falls between the small profits threshold and the lower profits limit, consideration must be given to the trader's other income. It could be counterproductive to secure a saving of Class 2 NICs (by removing a trader's need to make voluntary contributions), but then face an even higher income tax liability overall.

Benefits claimants

As always when advising those on lower incomes, it is important to bear in mind any interaction that planning might have with benefits entitlements.

As already discussed above, if a trader is receiving means-tested benefits (including working tax credit or universal credit), then they may also be entitled to Class 1 or Class 3 NI credits. Traders in this situation will be less likely to be concerned about securing Class 2 National Insurance 'treated as paid', as they might already have a 'qualifying year' for National Insurance purposes.

It cannot, however, be assumed that a trader with low profits will be otherwise receiving means-tested benefits that will provide Class 1 or Class 3 NI credits. For example, a trader might have low self-employed profits and low levels of overall income but have a wealthier partner, which may mean they are ineligible for means-tested benefits based on their household income. This trader's priority may be to ensure they are still entitled to a full state pension on retirement and so will be very keen to ensure that they have a full contribution record.

It is worth remembering that child benefit claimants will also be entitled to Class 3 NI credits, unless they elect for the credits to be allocated to another family member providing childcare as 'specified adult childcare credits'. Indeed, on the flipside you might be dealing with a trader who is entitled to claim specified adult childcare credits if they provide care for a related child under the age of 12, and the person who claims child benefit for that child does not need the associated NI credit. These are all potential areas to explore before considering the Class 2 NICs position.

In summary

It is probably safe to say that in the grand scheme of tax savings, spending a lot of time looking at this issue is unlikely to be terribly high priority for many advisers. However, it is useful to highlight these changes to Class 2 NICs as, for some traders, ensuring they have a qualifying year for NI purposes is important.

Image

WINDOW CLEANER TIMOTHY: CHOOSING WHETHER TO CLAIM TRADING ALLOWANCE

Timothy is a window cleaner who lives in England and makes his accounts up to the 5 April each year. His turnover for the year ending 5 April 2023 is £8,000 and his total business expenses are £2,500. After tax adjustments of £200, Timothy's taxable profit is £5,300 – below the small profits threshold. He also inherited two rental properties in 2021. The profit from his property business is £12,700 for the year ending 5 April 2023.

Timothy wants to know if he would be better off claiming the trading allowance to bring his trading profit above the small profits threshold.

Claim for trading allowance

	£
Trading income (8,000 less trading allowance)	7,000
Property income	12,700
	19,700
Less: Personal allowance	(12,570)
Taxable income	7,130
Income tax at 20%	**1,426**

In this case, Timothy's level of profit will fall within the small profits threshold and lower profits limit. Therefore, Class 2 NICs will be *treated as paid*, without him having to actually make a payment.

No claim for trading allowance

	£
Trading income (under usual principles)	5,300
Property income	12,700
	18,000
Less: Personal allowance	(12,570)
Taxable income	5,430
Income tax at 20%	**1,086**

In this case, Timothy would pay less income tax overall, but his profits would fall below the small profits threshold. He would therefore need to make voluntary Class 2 NICs to ensure that he had a qualifying year for his National Insurance record. Taking Timothy's combined income tax and voluntary Class 2 NICs liability (£3.15 x 52 = £164), his total liability for the year is £1,250, compared to £1,426 where a claim for the trading allowance is made. In this case, Timothy is better off accepting that his profits are less than the small profits threshold and paying voluntary Class 2 NICs contributions to secure a qualifying year.