

# The single-tier pension and people who have spent time in self-employment

## Background:

1. This note has been produced to provide additional detail on the effects which the introduction of the single-tier pension may have on people who have spent time in self-employment.
2. This note outlines in order:
  - a. The pattern of self-employment
  - b. The mechanics of the policy
  - c. Case studies
  - d. Annexes showing historical Class 2 and 4 rates

## Defining self-employment:

3. There is no single definition of what constitutes a self-employed person. However, broadly speaking, an individual is considered to be self-employed if they provide services but do not have a contract of employment.<sup>1</sup>

## Section 1: The Pattern of Self-Employment

4. The UK has an estimated 4.8 million businesses.<sup>2</sup> The structure of businesses run by people who consider themselves to be self-employed differs, with the key differences being those between a sole proprietorship, partnership, and a limited company:
  - **A sole proprietorship** (run by the 'sole trader') is the simplest form of business structure: ownership and control of a business rests with a single individual, as do all the risks and rewards.
  - **A partnership** is the relationship that exists between persons carrying on business together with a view to a profit: ownership and control of the business rests with the partners, as do all the risks and rewards.
  - **A limited company** creates a legal entity which owns and carries on the business; shareholders own the company and limit their own liability to the extent of their shareholding.

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<sup>1</sup> See Annex A for a range of definitions.

<sup>2</sup> Department for Business, Innovation & Skills (2012), *Business Population Estimates for the UK and Regions 2012*, available at: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/16400/12-92-bpe-2012-stats-release.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/16400/12-92-bpe-2012-stats-release.pdf)

5. An estimated 62.7% (around 3 million) of UK businesses are sole proprietorships, and approximately 10% of these sole proprietorships are also employers.<sup>3</sup> In 2012 around 70% of the self-employed were men.
6. Many people who decide to start their own business initially do so as a sole trader, owing to the administrative and legal simplicity involved in starting out. However, as a business grows and, for example, begins to need external investment or starts to employ many people, the legal and tax advantages may mean that people running a sole proprietorship decide to turn their business into a limited company.
7. From a National Insurance perspective, individuals who are sole traders pay Class 2 (a flat rate payment of £2.65 per week in 2012/13) and perhaps also Class 4 NICs (variable and dependent on profit),<sup>4</sup> whereas those running a limited company will be paying Class 1 NICs, as they will be employed by the company they run.
8. Table 1 shows that the number of people in the 2010/11 tax year who gained a qualifying year exclusively through payment of Class 2 NICs totalled approximately 1.9 million, representing around 6% of the total population who gained a qualifying year in that tax year.<sup>5</sup> The number has remained relatively stable in the recent past, ranging between 1.8 million and 2.1 million in the preceding 13 tax years. In comparison, in 2010/11, approximately 22.4 million people gained a qualifying year exclusively through Class 1 contributions.
9. Around four million profit-making self-employed people are liable to pay Class 2 NICs. Some of these people will concurrently be employed and self-employed, and will be paying enough Class 1 NICs through their employment to gain a qualifying year. Individuals who earn less than £5,595 per year can apply for a Certificate of Small Earnings Exception and not pay Class 2 National Insurance contributions.

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<sup>3</sup> *Ibid.*

<sup>4</sup> See Annex B for the historical rates of Class 2 and 4 NICs from 1975.

<sup>5</sup> A qualifying year is one in which there are sufficient National Insurance contributions to make that year count for state pension purposes.

**Table 1: People gaining a qualifying year through Class 2 contributions (or combinations where Class 2 is required to make up a qualifying year, thousands) by tax year:<sup>6</sup>**

	Class 2 only	Class 1 and 2	Class 2 and 3	Class 1, 2, and 3	Class 2 and Credits	Class 1, 2, and Credits	Class 2, 3, and Credits	Class 1, 2, 3, and Credits	Total qualifying years gained, all combinations of NICs and Credits
Apr-97	1,825	45	8	* 2	120	4	5	-	32,350
Apr-98	1,804	42	12	* 2	104	3	3	-	32,664
Apr-99	1,846	45	12	* 1	109	3	3	-	33,085
Apr-00	1,937	53	9	* 2	116	3	* 2	* 1	33,429
Apr-01	2,025	62	10	* 2	109	4	* 2	-	33,513
Apr-02	2,088	74	14	3	105	4	3	* 1	33,566
Apr-03	2,108	76	15	4	106	4	* 1	-	33,762
Apr-04	2,134	68	13	* 2	98	4	3	-	33,798
Apr-05	2,127	67	11	* 2	98	4	* 2	-	34,106
Apr-06	2,097	60	9	* 2	94	4	* 2	-	34,130
Apr-07	2,081	65	8	* 2	87	4	* 1	-	34,327
Apr-08	2,033	58	3	-	95	5	* 1	-	34,242
Apr-09	1,965	55	* 2	-	100	6	* 1	-	33,547
Apr-10	1,873	48	-	-	68	4	-	-	31,091

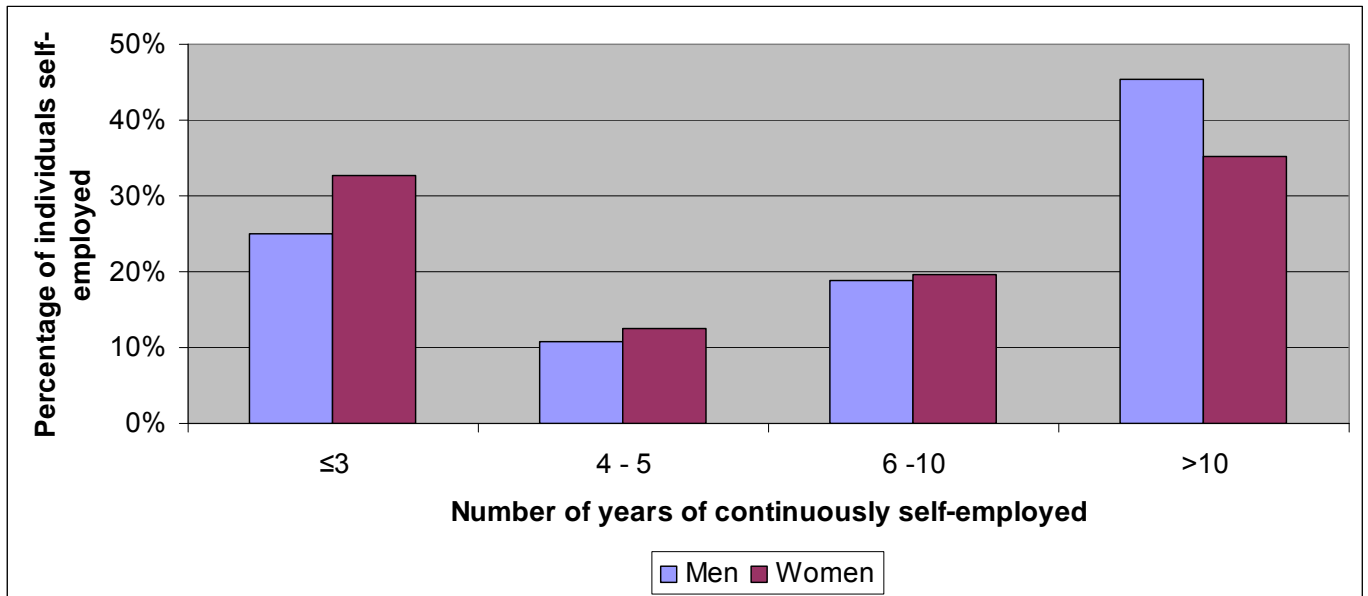
<sup>6</sup> DWP Tabulation Tool:

[http://83.244.183.180/NIRS/live/cq/ccdate/qualtype/a\\_qualifyingall\\_r\\_ccdate\\_c\\_qualtype.html](http://83.244.183.180/NIRS/live/cq/ccdate/qualtype/a_qualifyingall_r_ccdate_c_qualtype.html),

\*\*\* Figures are subject to a high degree of sampling error and should only be used as a guide.

10. Chart 1 shows that approximately 40% of people who are self-employed have been so for longer than ten years, and around 30% have been so for three years or less, with the median duration of self-employment being somewhere between six and ten years. This supports the assertion that the majority of people do not remain self-employed for all of their working lives, and that many transition between self-employment and other economic or social activities.

**Chart 1: Duration of self-employment:<sup>7</sup>**



<sup>7</sup> Reproduced from; UK Commission for Employment and Skills, (2011) *Annex LFS Analysis*, available at: <http://www.ukces.org.uk/assets/ukces/docs/publications/evidence-report-31-annex-lfs-analysis.pdf>

11. Table 2, below, shows the income distribution of profit-making self-employed people. It can be seen that of all the self-employed people making a profit, approximately half make less than £7,500 per annum.

12. The mean average profit for these individuals is approximately £17,000, although this figure will include the profits of many people who work self-employed part year, or those with concurrent employment.

**Table 2: Self-employed by income grouping:<sup>8</sup>**

Range of Self-employed income (lower limit)	Number of Individuals (thousands)	Percentage of individuals	Amount (£millions)	Average Income £
£1	376	9%	£168	£400
£1,000	282	6%	£418	£1,500
£2,000	266	6%	£662	£2,500
£3,000	250	6%	£874	£3,500
£4,000	264	6%	£1,190	£4,500
£5,000	752	17%	£4,650	£6,200
£7,500	431	10%	£3,740	£8,700
£10,000	553	13%	£6,810	£12,300
£15,000	365	8%	£6,310	£17,300
£20,000	381	9%	£9,250	£24,300
£30,000	244	6%	£9,200	£37,700
£50,000	126	3%	£8,770	£69,600
£100,000	96	2%	£25,100	£261,500
<b>Total</b>	<b>4,386</b>	<b>100%</b>	<b>£77,142</b>	<b>£17,600</b>

## Section 2: Policy

### Current system:

13. In the current pension system, Class 1, 2, and 3 contributions are treated equally for the purposes of gaining a qualifying year for the basic State Pension. The 'basic State Pension value' of one year's worth of these contributions is £3.58 per week.<sup>9</sup> Class 4 NICs do not attract any benefit entitlement and are therefore not considered for the purposes of calculating state pension entitlement.

14. Class 1 contributions have historically counted towards SERPS (State Earnings Related Pension Scheme) and currently count towards S2P (State Second Pension), whereas Class 2, 3, and 4 do not. This means that, in the most extreme case, an individual who has been self-employed

<sup>8</sup> Adapted from; HMRC (2012), *Survey of Personal Incomes, 2010-11*, available at: <http://www.hmrc.gov.uk/statistics/income-by-year/table3-10.xls>. Individuals who earn less than £5,595 per year can apply for a Certificate of Small Earnings Exception and not pay Class 2 National Insurance contributions.

<sup>9</sup> This is the full basic State Pension of £107.45 divided by 30 qualifying years (2012/13 terms)

for their entire working life, paying only Class 2 and 4 NICs, could expect only the maximum amount of basic State Pension of £107.45 in 2012/13 terms.

15. While these classes of NICs do not count for additional State Pension, crediting arrangements *do* apply for people paying these classes of NICs. Therefore, for example, an individual who is receiving Child Benefit for a child under 12 and who is also self-employed paying Class 2, will accrue S2P, just like everyone else receiving this NI credit.
16. Historically, a minority of self-employed individuals have saved into a private pension scheme (21% of all people self-employed, compared to 50% of all employees).<sup>10</sup> There is a chance that those who have spent substantial proportions of their working lives paying Class 2, and who have minimal assets or income streams may have to rely on Pension Credit in their retirement.

### **Single-tier system:**

17. The single-tier pension is designed to give working age people the clarity and confidence they need to better understand how much they need to be saving in order to achieve the income they want for their retirement.
18. Under the Government's proposals, Class 1, 2, and 3 contributions, as well as crediting, will be treated equally in the single-tier system, and the single-tier 'pension value' of one year's worth of these contributions or credits (or combination of these) will be £4.11 per week.<sup>11</sup>
19. This will provide individuals with the clarity they need to save for their retirement. The increased value of a qualifying year gained through Class 2 contributions will also help improve state pension outcomes for self-employed individuals. This is significant both because individuals who are self-employed have a lower participation in private pension saving and also because they will not be eligible for automatic enrolment and an employer's contribution (they can, however utilise a low cost accessible pension saving vehicle through making voluntary contributions to NEST).

### **Transitioning to the single-tier system:**

20. The Government proposes to treat Class 1, 2, and 3 contributions, as well as crediting, equally for the purposes of the single-tier valuation at the point of single-tier's implementation. This means that, as at the point of implementation, every Class 2 qualifying year will be valued under the current system valuation (at the rate of £3.58 per week for basic State Pension) and the single-tier valuation (at the rate of £4.11 per week).<sup>12</sup> The individual will then receive the higher valuation, based on their entire

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<sup>10</sup> DWP (2012), *Family Resources Survey, UK, 2010/11*, available at: [http://research.dwp.gov.uk/asd/frs/2010\\_11/frs\\_2010\\_11\\_report.pdf](http://research.dwp.gov.uk/asd/frs/2010_11/frs_2010_11_report.pdf)

<sup>11</sup> This is the illustrative full single-tier amount of £144 divided by 35 qualifying years (2012/13 terms).

<sup>12</sup> See the technical note on the transition to single tier, available at: <http://www.dwp.gov.uk/policy/pensions-reform/state-pension/>

NICs record up to the date of the introduction of the single-tier pension, as their Foundation Amount.<sup>13</sup> Many individuals will then be able to build upon this amount with further qualifying years gained (at the rate of £4.11 per qualifying year), until they reach the full level of single tier.

### **Future NICs rates:**

21. HMT will continue to annually review the levels of all Classes of NICs in order to make sure they remain in line with inflation and are sufficient to fund contributory benefits. Historical Class 2 rates from 1975 can be found in Annex B.

## **Section 3: Qualitative Case Studies**

22. The following case studies are for illustrative purposes, and show how Class 2 qualifying years gained before the introduction of single tier will be taken into account during the transition to single tier.

**Case Study 1:** *At the time the single-tier pension is introduced, John has been working as a taxi driver for the past 37 years, gaining qualifying years for all of those years through Class 2 contributions.*

John's pre-implementation NICs record is valued under both the current system rules and single-tier rules. Under the current system, Class 2 NICs only count towards the basic State Pension (maximum of £107.45 per week). Therefore, John's contributions are worth the full level of the basic State Pension (£107.45/30 x 30).

However, under the single-tier pension, Class 1, 2, and 3 NICs and Credits will all be valued equally – at the rate of £4.11 (to the nearest penny) per qualifying year. John's single-tier valuation is therefore the full level of single tier (£144/35 x 35).

John gets the single-tier valuation as his Foundation Amount and, because he already has the full level of single-tier, he cannot get extra pension by gaining further qualifying years.

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<sup>13</sup> For a description of the Foundation Amount, see [The single-tier pension: a simple foundation for saving](#).

**Case Study 2:** *At the time the single-tier pension is introduced, Rita has been running her own corner shop for the past 20 years, gaining qualifying years for all of those years through Class 2 contributions.*

Rita's pre-implementation NICs record is valued under both the current system rules and single-tier rules. Under the current system, Class 2 NICs only count towards the basic State Pension (maximum of £107.45 per week). Therefore, Rita's contributions are worth £71.63. ( $£107.45/30 \times 20$ ).

However, under the single-tier pension, Class 1, 2, and 3 NICs and Credits will all be valued equally – at the rate of £4.11 (to the nearest penny) per qualifying year. Rita's single-tier valuation is therefore £82.29 ( $£144/35 \times 20$ ).

Rita gets the single-tier valuation as her Foundation Amount and will be able to build on this at the rate of £4.11 (to the nearest penny) per qualifying year gained, through paying Class 1, 2 or 3 NICs, or through receiving Credits, until she reaches the full £144 level of the single-tier pension.

**Case Study 3:** *At the time the single-tier pension is introduced, George has been self-employed as an electrician for 12 years, gaining qualifying years for all of those years through Class 2 contributions. Before that, he worked for 5 years with a national company as an electrician, during which time he was paying Class 1 contributions.*

George's pre-implementation NICs record is valued under both the current system rules and single-tier rules. Under the current system, Class 2 NICs only count towards the basic State Pension (maximum of £107.45 per week). Therefore, George's time spent self-employed will only count towards the basic State Pension. His time spent as an employee, paying Class 1 NICs, will also count towards the basic State Pension and, assuming George wasn't contracted-out, also some additional State Pension, dependent on his earnings.

Under the single-tier pension, Class 1, 2, and 3 NICs and Credits will all be valued equally – at the rate of £4.11 (to the nearest penny) per qualifying year. George's single-tier valuation will therefore value equally his Class 1 and 2 contributions for the purposes of calculating his Foundation Amount. Under the current system valuation, George's 17 qualifying years will be taken into account, as will any additional State Pension.

George will receive the higher of these valuations as his Foundation Amount, and will be able to build on it at the rate of £4.11 (to the nearest penny) per qualifying year gained, until he reaches the full £144 of single tier.



## Annex A: Definitions of self-employment

There is no simple definition of self-employment. There are guidelines laid out by HMRC and The Employment Act of 1996; Employment status isn't a matter of choice for either the engager or the worker: It is a matter of fact based on key terms and conditions of the working relationship. Ultimately the decision rests with the courts in any dispute or tribunal.

**Employment Rights Act 1996** Section 230(1) of the Employment Rights Act of 1996 defines an employee as:

- 'an individual who has entered into or works under...a contract of employment'.

Section 230(2) goes on to say:

- "in this act 'contract of employment' means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing".

### **The Court**

The Court will also consider whether a contract exists between the individual and the alleged employer, and, if it does, the nature of that contract is then examined. A contract of service is regarded as a contract of employment, whereas an individual who contracts to provide tangible goods or services is regarded as self-employed under the common law, and is engaged under a contract for services. This is established by considering a number of factors:

- control
- personal service
- equipment
- financial risk
- basis of payment
- holiday pay, sick pay and pension rights
- part and parcel of the organisation
- right to terminate a contract
- opportunity to profit from sound management
- personal factors
- length of engagement
- intention of the parties

When the facts have been established, the approach is to stand back and look at the picture as a whole. It can then be seen whether the overall effect is that of a person in business on his/her own account or a person working as an employee in somebody else's business.

HMRC also provides an online tool, the Employment Status Indicator (ESI) which enables an employer (or worker) to check the employment status of an individual or group of workers - that is, whether they are employed or self-employed for tax, National Insurance contributions (NICs) or VAT purposes, available at: <http://www.hmrc.gov.uk/calcs/esi.htm>

## Annex B: Class 2 and 4 rates, 1975 – 2013:14

Year	Lower Profit Limit (LPL) (£p.a.)	Upper Profit Limit (UPL) (£p.a.)	Class 2 rate (£p.w.)	Class 4 rates (%)	
				Between LPL and UPL	Above UPL
1975-76	1,600	3,600	2.41 <sup>b</sup>	8.0	0
1976-77	1,600	4,900	2.41 <sup>c</sup>	8.0	0
1977-78	1,750	5,500	2.66 <sup>d</sup>	8.0	0
1978-79	2,000	6,250	1.90	5.0	0
1979-80	2,250	7,000	2.10	5.0	0
1980-81	2,650	8,300	2.50	5.0	0
1981-82	3,150	10,000	3.40	5.8	0
1982-83	3,450	11,000	3.75	6.0	0
1983-84	3,800	12,000	4.40	6.3	0
1984-85	3,950	13,000	4.60	6.3	0
1985-86 <sup>a</sup>	4,150	13,780	4.75	6.3	0
1986-87	4,450	14,820	3.75	6.3	0
1987-88	4,590	15,340	3.85	6.3	0
1988-89	4,570	15,860	4.05	6.3	0
1989-90	5,050	16,900	4.25	6.3	0
1990-91	5,450	18,200	4.55	6.3	0
1991-92	5,900	20,280	5.15	6.3	0
1992-93	6,120	21,060	5.35	6.3	0
1993-94	6,340	21,840	5.55	6.3	0
1994-95	6,490	22,360	5.65	7.3	0
1995-96	6,640	22,880	5.75	7.3	0
1996-97	6,860	23,660	6.05	6.0	0
1997-98	7,010	24,180	6.15	6.0	0
1998-99	7,310	25,220	6.35	6.0	0
1999-00	7,530	26,000	6.55	6.0	0
2000-01	4,385	27,820	2.00	7.0	0
2001-02	4,535	29,900	2.00	7.0	0
2002-03	4,615	30,420	2.00	7.0	0
2003-04	4,615	30,940	2.00	8.0	1
2004-05	4,745	31,720	2.05	8.0	1
2005-06	4,895	32,760	2.10	8.0	1
2006-07	5,035	33,540	2.10	8.0	1
2007-08	5,225	34,840	2.20	8.0	1
2008-09	5,435	40,040	2.30	8.0	1
2009-10	5,715	43,875	2.40	8.0	1
2010-11	5,715	43,875	2.40	8.0	1
2011-12	7,225	42,475	2.50	9.0	2
2012-13	7,605	42,475	2.65	9.0	2

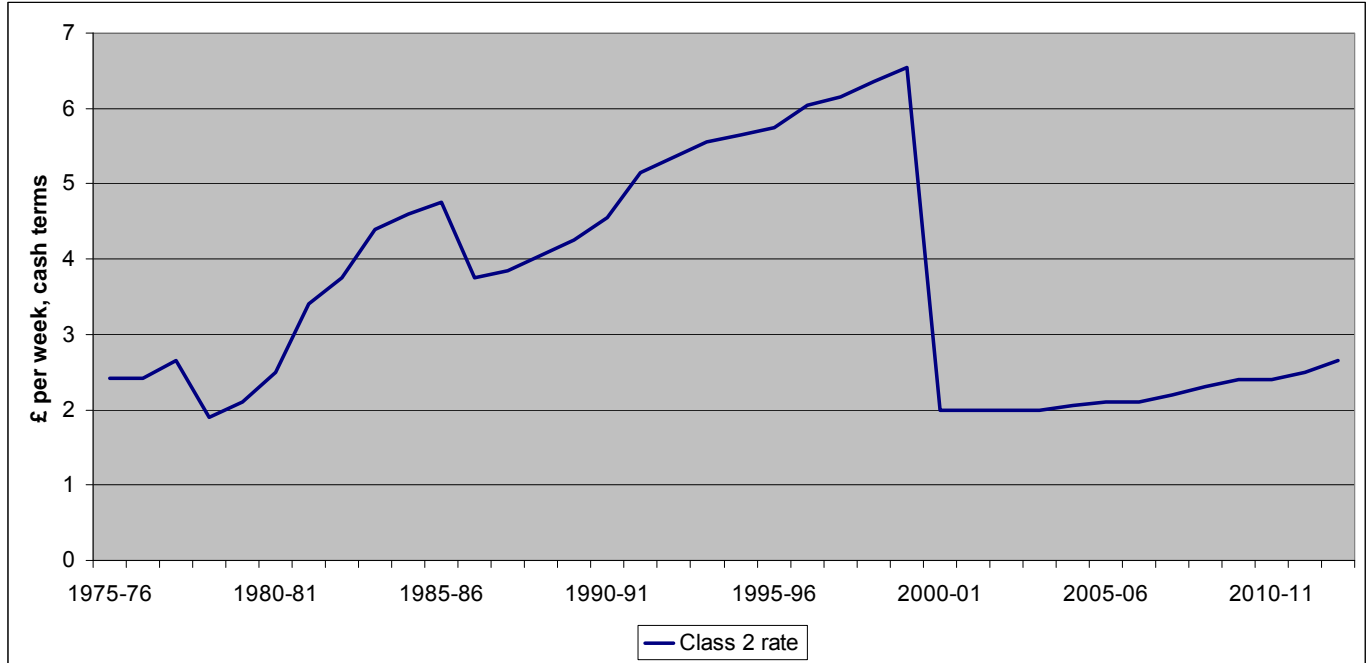
<sup>14</sup> HMRC (2012), *National Insurance contributions for the self-employed*, available at: <http://www.hmrc.gov.uk/rates/archive.htm>

**Footnotes:**

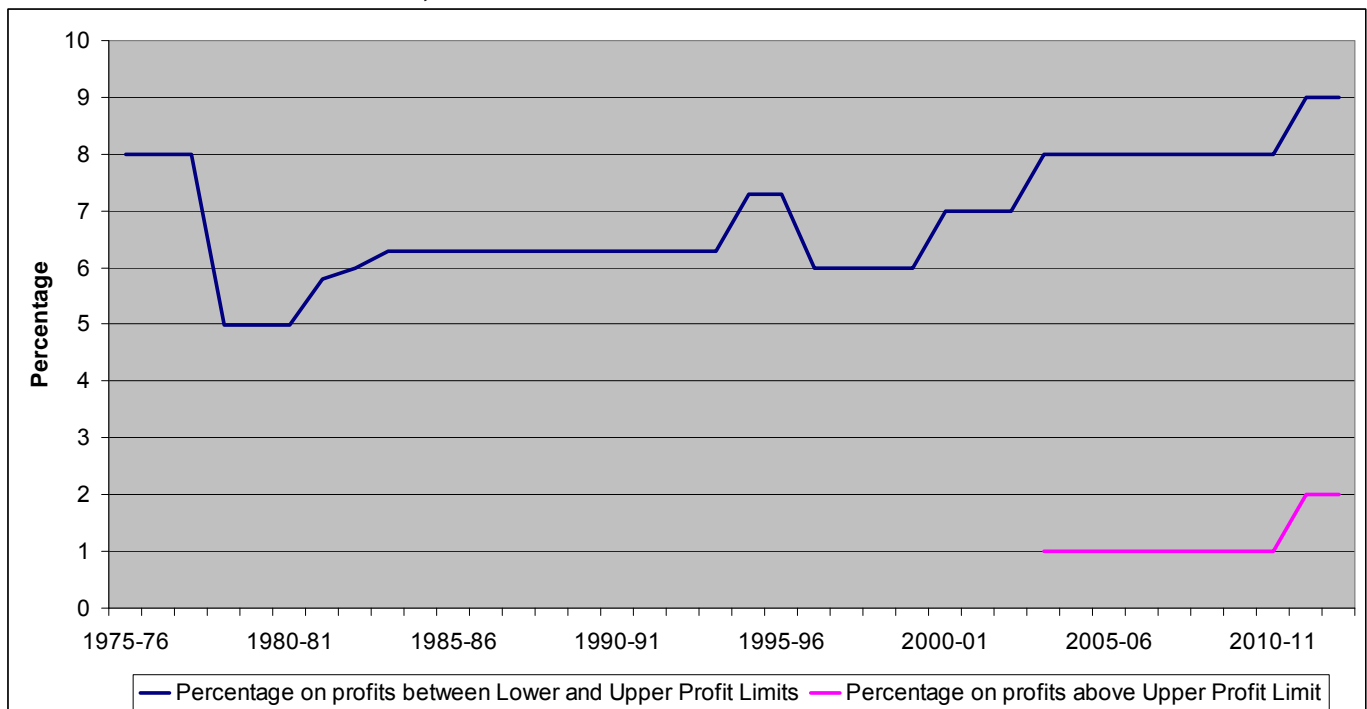
(a) On 6 October 1985 the Class 2 rate fell to £3.50.  
(c) £2.20 p.w. for women.

(b) £2.10 p.w. for women.  
(d) £2.55 p.w. for women.

**Chart B.1: Class 2 rates per week, 1975-2013, cash terms:**



**Chart B.2: Class 4 rates, 1975-2013:**



**Chart B.3: Class 4 Lower and Upper Profit Limits, 1975-2013, cash terms:**

