ipse The Association of Independent Professionals and the Self Employed

Off-payroll working in the public sector: reform of the intermediaries legislation
IPSE response to the HMRC consultation document

August 2016

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Contents

1. Summary of IPSE's position

IPSE believes the application of this proposal will be damaging, not just to the Personal Service Companies and the agencies in the supply chain, but to their public sector clients. The proposal will:

- Add huge complexity to an already overly complex tax system
- Not generate the revenue anticipated
- Cost the government much more to administer than predicted
- Prevent the public sector from accessing the specialist skills it needs to deliver vital public services
- Reduce flexibility in the supply of those specialist skills
- Further complicate employment status
- Give rise to legal challenges, particularly with regard to employment rights and status appeals
- Damage SMEs in the supply chain and will negatively impact the Government's target that 33% of its spending should flow to SMEs by 2020[1].

1.1 Brexit

IPSE believes this proposal would be damaging whenever it was introduced, however, it must now also be considered in the context of Brexit. The economy is in a fragile state. The Bank of England's decision, earlier this month, to cut interest rates to a record low 0.25% and increase its quantitative easing programme, was a measure designed to shore up confidence at a difficult time.

Now more than ever the government needs to prioritise the issues it takes forward. Moving ahead with a measure that will restrict the benefits of the UK's flexible labour market – one of our greatest economic advantages - risks damaging the economy at a time which is already challenging for businesses.

1.2 Recommendations

For the reasons set out above, **IPSE's central recommendation is that the proposal should be abandoned**.

Recommendation 1 – the proposal should be abandoned.

This submission to the consultation will set out why IPSE believes strongly that this proposal, if implemented, will be more harmful than beneficial. It also makes further recommendations for the government's consideration:

Recommendation 2 - Adopt the Freelancer Limited Company

Recommendation 3 - Government should undertake a strategic review of the taxation of income

Recommendation 4 - If the government wants the people that work for it to pay employment taxes, it should employ them

[1] National Audit Office https://www.nao.org.uk/governments-spending-with-small-and-medium-sized-enterprises/ March 2016

Should the government persist with the proposal, contrary to recommendations 1 – 4 above, IPSE would make the following, further recommendation:

i) Delay implementation of the proposal until there is consensus that the online tool works

2. About IPSE:

- The Association of Independent Professionals and the Self Employed (IPSE) represents the estimated 4.8 million individuals working for themselves in the UK.
- IPSE has approximately 21,000 members.
- Over 98% of our members work through their own limited companies.

2.1 Independent Professionals

Often referred to as freelancers, contractors, consultants and nano-businesses, independent professionals are highly skilled specialists supplying their expertise on a flexible basis to a variety of businesses - from large companies to SMEs **to public sector bodies**.

Frequently, independent professionals will be incorporated businesses. This is driven by commercial necessity. The clients and agencies that engage independent professionals insist on the limited company structure as it protects them from potential employment rights and tax liabilities. These businesses have in recent years begun to be labelled as 'personal service companies'.

2.2 'Personal Service Companies' (PSCs)

To ensure clarity of understanding, in this response IPSE will use the term 'personal service company' (PSC). However, the term is problematic. There is no statutory definition of a 'PSC'. Legally, there is nothing which distinguishes a PSC from any other limited company. Nevertheless, the consultation document frequently refers to PSCs. IPSE understands the government is referring to what one might describe as 'limited company contractor businesses'.

3. About this response:

This response has been based on

- Independent research by Oxford Economics – full reports available in Appendix A & Appendix B
- A survey of 829 public sector PSCs – full survey results are available in Appendix C
- Roundtable events with members, HMRC and other stakeholders and experts
- Collecting case studies from those likely to be impacted
- Face to face consultation with IPSE's membership
- Discussion on IPSE's online forum

3.1 The proposal applies in the public sector only?

The consultation document clearly states the rules in the private sector will not change. Despite this, almost all independent tax and legal experts IPSE has spoken to remain convinced that it is the government's intention to roll out the new regime across all sectors, in due course. This is because to have two different regimes relating to the same legislation and case law will add considerable complexity (the complexity issue is discussed later in this response).

On the basis of the advice IPSE has received, this response occasionally considers what might happen were the proposal to be rolled out in the private sector. Mainly, though, it focuses on the impact of the proposal on the public sector.

3.2 The 'engager' can be the public sector body or the recruitment agency

During this response we use the word 'engager'. This can mean the public sector body or end client who ultimately receives the benefit of the work undertaken by the PSC. It can also mean the agency with which the PSC has a contract. This is because either the public sector body or the agency will have the responsibility to apply the new rules, if this proposal is implemented.

At other times during this response we specifically refer to the public sector body or the agency and consider the impact of the proposal on them separately. This is because the challenges they will face when attempting to implement the rules are different. Essentially it will be harder for an agency to make an IR35 determination than it will for the public sector body that works with the PSC on a day-to-day basis.

4. Everyone should pay correct taxes:

IPSE takes abuse of the tax system very seriously. Abuse of the system undermines those legitimately working in a flexible way such as limited company contractors. However, IPSE has serious concerns about the proposal laid out in the consultation document. This response details those concerns.

4.1 Recommendation 2 – adopt the Freelancer Limited Company

We also propose further consideration of the 'Freelancer Limited Company' (FLC) which we developed last year with EY. IPSE believes the FLC will provide clarity of status for freelancers that chose it and protect revenue. We have had preliminary discussions with HMRC and HMT officials on the FLC and we hope more progress can be made.

IPSE developed the FLC in response to the continued focus on PSCs from policymakers. The operating environment for PSCs has become increasingly complex. The proposal under consultation here will make that environment even more complex. The idea of the FLC is to remove these businesses from increasingly complex regulations and allow them to focus on making a positive contribution to the economy. A paper on the FLC is available in Appendix D.

5. IR35 is ineffective and should be abolished

5.1 IR35 is inherently flawed

It creates unnecessary risks and uncertainty for the very smallest businesses in the UK, while raising hardly any revenue for the government. HMRC figures show yield fell from £1.1m in 2012/13 to £430,000 in 2013/14.[2]

The legislation is so unclear it is impossible to know whether an individual engagement falls within IR35's scope. This means contractors spend large amounts of time and money attempting to understand their IR35 status. Research by ComRes in 2009 estimated this costs £853 per year on average per contractor.[3]

[2] Answer to Parliamentary Written Question by Pamela Nash MP, Rt Hon David Gauke MP, February 2015
[3] ComRes, *A Survey of IPSE membership,* October 2009

For those businesses investigated, significant disruption and costs will be incurred. It is IPSE's understanding that in most cases, investigations do not result in additional tax being paid.

For these reasons IPSE has consistently called for IR35 to be abolished.

5.2 Recommendation 3 – Government should undertake a strategic review of the taxation of income

Nevertheless IPSE recognises the dramatic and continued changes in the labour market present the Exchequer with a significant challenge. The traditional model of employers and employees is eroding. The number of self-employed continues to rise – currently 4.8million; 15% of the workforce – and the proliferation of online platforms and the sharing economy is set to keep growing.

All this new economic activity presents a big opportunity for the UK but consideration needs to be given to clarifying the employment and tax status of those that drive it. The tax system needs to be radically overhauled in order to keep pace. Tinkering with IR35, which already doesn't work, is insufficient.

IPSE believes the government should undertake a strategic review of income taxation, taking into account the rapidly changing world of work. This should be a wide ranging review, consulting closely with external organisations and experts, and pulling together different strands of work that have already been done, notably by the Office of Tax Simplification[4].

6. IPSE does not agree that non-compliance with IR35 is widespread

The foreword to the consultation document states, 'There is evidence of widespread non-compliance with the *(intermediaries)* legislation.'[5]

IPSE does not agree that non-compliance is widespread and would be interested to see the evidence referred to.

In March 2015, government published an evaluation of compliance with the 'off-payroll' rules.[6] It found "95% of government departments were broadly compliant in ensuring that their contractors provided satisfactory assurance that their tax affairs were in order". It is hard to tally this evaluation with the statement that 'non-compliance is widespread'.

However, if there is evidence of non-compliance, it would be more effective for government to use it to enforce the current IR35 rules, rather than introduce new legislation that will cause significant problems in the public sector.

6.1 Government figures used in the consultation document

The government estimates only 10% of PSCs who should be operating IR35 on at least part of their income are doing so. This non-compliance is estimated to cost the Exchequer £440m in tax year 2016 to 2017. IPSE would be interested to understand more about how government has arrived at these figures.

[4] See, for example, the OTS reports on Small Company Taxation, March 2016 and Employment Status, March 2015
[5] Off-payroll working in the public sector, HMRC, p.4 Published May 2016
[6] Second evaluation of tax arrangements for off-payroll contracts in the public sector, HM Treasury, March 2015

It is impossible to know with any certainty whether even one engagement is caught by IR35. It seems impossible therefore to determine how many IR35 caught engagements exist in total, across the UK, and therefore what the cost of non-compliance really is. If government has been able to calculate this, IPSE would be interested to understand how.

6.2 PSCs make a positive contribution

IPSE acknowledges the consultation document also notes the positive contribution of PSCs:
"PSCs have a place in the labour market as they enable businesses to flex their workforce easily based on demand and quickly engage individuals with skills required for short-term, contained pieces of work."[7]

7. The economic contribution of PSCs

7.1 The overall contribution of PSC across the economy

IPSE commissioned Oxford Economics to carry out research into the economic activity and value that PSCs contribute to the UK. This research covers PSC activity in both the private and the public sector. IPSE believes it is important the government considers this, as although the proposal will only impact the public sector, most, in fact almost all stakeholders, believe government will at some stage seek to apply it in the private sector as well.

The report (Appendix A) is based upon HMRC's estimate there were around 265,000 active PSCs in the UK in 2012/13. The report estimates this has grown to 307,000 PSCs operating in the UK in 2015. Business turnover was calculated using IPSE's survey data collected from the quarterly Freelancer Confidence Index. This found the average PSC had an income of £78,800 in 2015.

Oxford Economics found the 307,000 **PSCs contributed a total of £37.9bn to the UK economy** in 2015. This is broken up into three elements, their direct, indirect and induced contributions:

<u>DIRECT</u> – PSCs directly contributed £21.3 billion to UK GDP in 2015. This is derived from their combined turnover of £24.2 billion. Their collective contribution to the UK economy made an economic contribution to UK GDP that was larger than the whole mining and quarrying industry, or all of the UK civil engineering sector.

<u>INDIRECT</u> – Their indirect contribution is the purchase of goods and services in the operation of their businesses. This includes expenditure on travel accommodation accountancy services and IT equipment. Oxford Economics estimates this to be £2.1 billion.

<u>INDUCED</u> – Lastly, another significant proportion of PSCs contribution to the economy is their consumer spending and that of the workers their economic activity as PSCs support. This induced effect totalled £14.5 billion in 2015.

In addition to the monetary benefits PSCs contribute to the economy there is also their contribution in terms of added employment, productivity and flexibility in the UK economy.

<u>EMPLOYMENT</u> - Alongside PSCs' contribution of £37.9 billion to GDP PSCs also have a marked impact on the labour market, despite rarely employing people themselves. Oxford Economics estimates these businesses supported 602,000 jobs in the UK in 2015. This includes the 307,000 people who operate

[7] Off-payroll working in the public sector, HMRC, p.7 Published May 2016

through PSCs, as well as another 43,000 jobs that were sustained in the supply chains of these businesses and an additional 252,000 jobs which were supported by the consumer expenditure of the freelancers that work through PSCs.

PRODUCTIVITY - The report also found that PSCs tend to be more productive than the average worker. Their comparative wage earnings were £69,400 per annum in 2015. This was 30% higher than the UK average contribution per worker.

FLEXIBILITY – Finally PSCs add an efficiency value to their clients by working flexibly. As PSCs offer their work on demand they are at work around 71% of their time. Many are available for more work than they can get contracts for but this is of benefit to their clients, who would otherwise incur the increased cost of having a permanent employee in a role. Oxford Economics estimates the value attributable to the benefits that PSCs provide clients, in terms of increased flexibility and reduced risk, amounted to £4.7 billion in 2015.

7.2 The contribution of PSCs, specifically in the public sector

As a follow up we asked Oxford Economics to conduct a similar analysis of the economic impact of PSCs that operate in the public sector (Appendix B). The government estimates there are around 26,000 PSCs working in the public sector.[8] The estimates of their output are again drawn from IPSE's quarterly Freelancer Confidence Index survey data and are assessed by direct, indirect and induced contributions.

DIRECT – The average annual income of PSCs working in the public sector was £84,300 in 2015. In total, they turned over in excess of £2.2 billion. The direct contribution these PSCs made to the UK economy is estimated to be £1.9 billion.

INDIRECT – The indirect contribution of PSCs working in the public sector to the economy through their supply chains is £200 million.

INDUCED – The wage related expenditure of PSCs working in the public sector and those whose jobs are supported in PSC supply chains is estimated to be £1.3 billion.

Overall PSCs in the public sector contributed £3.5 billion to the UK economy. The average turnover figure shows that PSCs in the public sector tend to be even more productive than the general population of PSCs. Public sector PSCs also support 52,900 jobs in total.

Other than the 26,000 jobs sustained by PSCs' own employment, 4,300 jobs are indirectly supported through PSC supply chains. The consumer expenditure created by PSCs also supports a further 22,600 jobs.

The proposal laid out in the government's consultation document will put this economic contribution at risk. This is because implementation of the proposal will lead to significant changes in the behaviour of PSCs. This was not considered in the consultation document's 'Summary of Impacts', but IPSE conducted a survey which shows that PSCs will in most cases stop contracting in the public sector, stop contracting altogether or increase their rates to compensate for the additional tax burden. The results of the survey are considered further in the next section.

[8] Off-payroll working in the public sector, HMRC, p.31 Published May 2016

8. Costs and risks of implementing the proposal

In order to understand the impact of the proposal on PSCs, IPSE conducted a survey to understand how the proposed changes might affect their business. This document provides results from a survey conducted between 14 June -25 July 2016, and compiled from the responses of 829 IPSE members and non-members who have worked on public sector contracts in the last two years.

8.1 Results of IPSE survey

The survey showed that if the proposal is enacted, it is likely to have an adverse effect on independent professionals' likelihood to work on public sector contracts.

Thirty-one per cent (31%) indicated they **would not work on public sector contracts** at all, rather than waiting to find out whether the rules would be applied to their engagement.

Some respondents would remain working on public sector contracts with caution or make adjustments to their rates to accommodate the changes.

Twenty-three per cent (23%) indicated they would continue to work on public sector contracts, **but if the new rules were applied to their engagement and their business was required to pay the same tax and National Insurance as an employee, they will terminate their contract(s).**

Thirty-nine per cent (39%) indicated they would **increase their day rate** to compensate for the additional tax liability.

8.2 PSCs will cease to work for public sector clients

The survey results show 54% of those currently contracting in the public sector will cease to do so if the proposal is implemented. This is made up of the 31% that will not work on public sector contracts at all, rather than waiting to find out whether they are required to pay the same tax and National Insurance as an employee, and 23% that will leave only if their engagements are affected.

Because engagers are highly likely to apply the new rules to all engagements, regardless of the actual IR35 status (this point is covered in detail in the next section) we believe the total percentage of PSCs that contract with public sector clients will diminish by something close to 50%.

As the government has estimated that 26,000 PSCs will be impacted by the proposal, that's 13,000 engagements that will no longer be filled, preventing vital public services from being delivered.

8.3 The damage the proposal would do in the private sector

IPSE's survey demonstrates that thousands of contractors will leave the public sector and seek work in the private sector. IPSE is concerned this evidence could lead to government seeking to roll out the proposal to the private sector too, in an effort to collect more tax. Even without the incentive of capturing PSCs that have fled the public sector, most external commentators believe the proposal will be extended to the private sector in due course. This will be extremely damaging.

UK businesses rely on the specialist skills that contractors provide. As Professor Andrew Burke has set out, the flexibility that contractors offer enables businesses to maximise performance across peaks and troughs in demand. Further, Burke finds that contractors enable de-risking of some of the uncertainties of the market so that firms can reduce the risk of growing.[9]

If the proposal were extended to the private sector it would severely restrict flexibility and significantly damage the economy.

8.4 Resourcing public sector projects will become more expensive

Public sector bodies, in seeking to salvage and maintain projects, will have to find alternative resource. This could be achieved by engaging more employees, however, employment is frequently inappropriate for projects which have a finite end. It is also considerably less flexible and it carries significant additional costs and responsibilities. These include holiday pay, illness pay, pension entitlements and the inability to cut the cost of engaging the worker once the project has been completed.

Public sector bodies will be to forced to use staff from the ‘big four’ consultancies, to whom these rules will not apply. This will significantly increase the overall costs of filling the engagements as these consultants come at a premium which is well above the cost of engaging a PSC.

Either way the overall cost to the public sector will increase as a result of PSCs declining to engage.

8.5 PSCs will increase their day rates

Thirty-nine per cent (39%) of those we surveyed said they would continue to work with public sector clients but they would adjust their day rate to compensate for the additional tax liability. Clearly this will increase the cost for public sector clients, and increase the strain on public funds accordingly. It will also mean more tax is payable, but the increased cost will mean there is no net benefit to the Exchequer.

8.6 Some PSCs will cease trading altogether

Of those who said they would leave the public sector if the proposal was enacted **5%** would **retire earlier than planned.** This will result in less economic activity in the economy; a reduction in the economic contribution of PSCs (as quantified by the Oxford Economics research); and critically, less tax being paid. It also means that the some of the most experienced, and therefore most valuable, contractors will be lost.

8.7 Tribunal costs

The consultation document explains the process for appeals as follows:
“Where a PSC or an engager disagree with a determination that the new rules apply, the PSC and/or engager will be able to request a formal review of the decision and to appeal that decision to the tribunal”.[10]

The cost of defending a claim at tribunal varies depending on the case, but is rarely insignificant. If only one determination is challenged at tribunal, it is likely to use a significant proportion of the £500,000[11] HMRC has earmarked for implementing the new rules.

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[9] The role of Freelancers in the 21st Century British Economy, Professor Andrew Burke, 2012
[10] Off-payroll working in the public sector, HMRC, p.29 Published May 2016
[11] Off-payroll working in the public sector, HMRC, p.31 Published May 2016

IPSE believes the new rules will lead to several appeals. This is because many engagements will be deemed to be 'inside IR35' incorrectly as public sector bodies and agencies will be unsure and risk-averse. (Section 9 explores this point in more detail.) This will inevitably lead to PSCs seeking to challenge the determination, which will result in very significant costs.

Further tribunal costs will result from those seeking employment rights, as a result of being taxed like an employee. (Section 10 explores this point in more detail.)

8.8 Cost of providing support, advice and guidance to public sector bodies and agencies

As explored in more detail in the next section, engagers will not be able to easily determine whether IR35 applies to the engagements. Neither public sector bodies nor agencies are likely to have even a cursory understanding of the complex IR35 rules. They will need help in making those determinations. HMRC's recently published research found that engagers looking to 'get it right' in terms of compliance would look for guidance and advice from HMRC[12].

Published guidance will be insufficient, as will the new online tool (see section 11 on the tool). Engagers will want to pick up the phone and speak to an HMRC official about each engagement. The consultation document states that 26,000 PSCs will be affected. That means 26,000 decisions will need to be made on the status of the engagement and HMRC will need to provide advice on most of them.

This will require a huge amount of staffing resource and will carry significant cost.

On 27 July the Public Accounts Committee published a report raising concerns about HMRC's ability to deliver a quality service to taxpayers, outlining that 'plans to cut the cost of its personal tax services by another 34% in the next five years raise the risk of another collapse in service levels'[13]. The report also set out concerns that the move to a new IT model 'could bring substantial risks to tax collection and customer service'.

Following consultation with industry stakeholders, it is clear that engagers are likely to have problems implementing the new rules and will need detailed ongoing guidance and support from HMRC. Given HMRC's downsizing and transition to a new IT model, HMRC is unlikely to have the resources to provide this practical support that will be essential in helping public sector bodies and agencies cope with the new rules.

And what if PSCs that disagree with the status determination seek to reclaim the tax already paid? Will HMRC have the resource to undertake what will essentially be an IR35 investigation into potentially thousands of engagements?

9. Liability for determining whether IR35 applies should remain with the PSC

IPSE disagrees very strongly with a central tenant of this proposal that responsibility to apply IR35 should move to the public sector body, agency or other third party paying the worker's company.

[12] Intermediaries Legislation Qualitative Research, HMRC, published July 2016 p. 11
[13] Quality of service to personal taxpayers and replacing the Aspire contract. PAC, published July 2016.

9.1 Engagers will not be able to determine whether IR35 applies

As already stated IR35 is incredibly confusing. It is impossible to determine with any degree of certainty whether it applies to any one engagement. Historically HMRC has felt certain that IR35 does apply to a particular engagement, only for a tribunal to disagree – more recent examples include Primary Path Ltd, ECR consulting Ltd, MBF Design Services Ltd and Marlen Ltd. If HMRC, with all the expertise and resources it has, cannot make a correct judgement on IR35 status, how are public sector bodies or agencies that have no knowledge of the day-to-day characteristics of the engagement going to cope?

Engagers have no IR35 expertise whatsoever. They will have no way of knowing whether it applies or doesn't. Saddling engagers with such a burden creates a huge additional responsibility and one they will be ultimately unable to fulfil.

The proposal assumes public sector clients and/or agencies will take a considered view on whether IR35 applies to each individual engagement. Where the client is a comparatively small organisation, engaging one or two PSCs, this might happen. Larger organisations, however, which engage hundreds, maybe even thousands, of PSCs at any one time, will not consider engagements individually. To do so would incur a huge administrative effort that they do not have the resources to take on.

9.2 Public sector bodies and agencies are risk-averse

Clients and agencies will take a holistic approach to IR35. They will say either that the new rules apply to all engagements, or none of them. Both clients and agencies are considerably more likely to say the rules apply, as this will remove the risk of non-compliance.

Public sector organisations are risk-averse. They do not want to run the risk of incorrectly determining the status of an engagement, only to then be liable for tax further down the line. As they cannot know with any certainty whether IR35 should apply – due to its inherent uncertainty – they will have no choice but to determine that all engagements are 'caught'.

For agencies this problem is compounded as they will have no knowledge of the day to day working practices of the engagement, upon which IR35 status is determined. They are at arm's length from the engagement. They are not on-site and are not able to observe the interactions between the PSC and the client. There is, as far as IPSE can see, no conceivable scenario in which an agency will feel comfortable signing off an engagement as being outside IR35. Compliant agencies will have no choice but to determine that all engagements are 'caught'.

The proposal suggests a new online tool will enable clients and agencies to accurately determine status. Were this tool to work effectively, it would make the above points moot. However, IPSE believes the tool will not work (the tool is discussed in more detail in section 11).

9.3 In attempting to tackle 'disguised employment', this measure will create the opposite problem – 'disguised self-employment'

This will result in the creation of 'disguised self-employment': where the engagement will be one of self-employment, but will be taxed as if it were employment. Ultimately, the IR35 status decision being made by the client will lead to fully tax compliant public sector bodies, agencies and PSCs, paying incorrect amounts of tax.

9.4 HMRC research shows clients do not want the liability for determining IR35

Midway through the consultation period HMRC published research[14] it had commissioned last Autumn. The paper outlined the results of qualitative research undertaken by HMRC, with IPSOS Mori. 36 organisations in both the public and private sector were asked about the ideas discussed in last year's IR35 Discussion document. These were:

- Shifting IR35 liability onto the engager
- Replacing the IR35 tests with an SDC test

IPSE believes the research adds considerable weight to our concerns with the current proposal.

The research found engagers would not want IR35 liability to shift to them because:

1. **Administration** – engagers would have to bring in processes to check the tax circumstances of all 'temporary staff'. This would require new systems to be introduced which would have time and cost implications.
2. **Cost** – In addition to admin costs, engagers are concerned they'd be forced to employ more staff which would cost them more (as they would have to give them employee benefits). Ultimately, they may have to let some people go to keep costs down.
3. **Caution** – Employers will automatically put people on the payroll rather than risk non-compliance (and big penalties). **This will lower their flexibility.**

Impact on the PSCs

- Concerns were raised that PSCs would effectively be pushed into employment against their will. This could be very difficult if they are working for two or more organisations concurrently.
- Privacy and data protection – PSCs don't want to give personal information to their clients (which they would have to do if they were to go on the payroll). IPSE is aware that for many contractors the use, transmission and storage of this information, and questions over who would be data controller, is a major concern.

Business said they would need clear guidance and help from HMRC to administer the shift in liability **'but a strong feeling remains that this change would be difficult whatever help is offered.'**

In conclusion the research found 'the potential changes are not supported by businesses overall'[15]. Businesses saw changes as 'potentially costly, burdensome and constraining'[16]. And 'the potential change would result in a loss of flexibility'[17].

'It was also said the current economic climate meant this was not a good time to make this change for either the public or private sector'[18].

[14] Intermediaries Legislation Qualitative Research, HMRC, published July 2016
[15] Intermediaries Legislation Qualitative Research, HMRC, published July 2016 p.10
[16] Intermediaries Legislation Qualitative Research, HMRC, published July 2016 p. 10
[17] Intermediaries Legislation Qualitative Research, HMRC, published July 2016 p.7
[18] Intermediaries Legislation Qualitative Research, HMRC, published July 2016 p.7

9.5 Economic climate
This last point about the economic climate is even more relevant now, in the wake of Brexit and the concern around its impact on the economy. The flexibility and expertise independent professionals offer our economy sets the UK apart from international counterparts. As we negotiate our exit from the EU, government must do everything in its power to ensure the UK remains the most flexible economy in Europe. It is crucial to our future economic success.

HMRC's own research shows that this proposal will diminish flexibility, which is exactly the opposite of what we should be doing in the current economic climate.

10. Employment status v tax status

10.1 Recommendation 4 – If the government wants the people that work for it to pay employment taxes, it should employ them.
Instead this proposal seeks to deduct PAYE and NI without providing the benefits and protections that come with employment.

The consultation document states, *"For workers in the public sector this reform changes which party is liable to decide if a payment should be taxed as employment income. No changes will be made to existing employment law."*[19]

This will cause complexity, confusion and conflict. If workers are taxed like employees, as some will be under the proposal, it is likely, and not unreasonable, for them to expect employment rights. It will cause tensions between the worker and engager, which in turn will give rise (in all likelihood) to legal challenges.

10.2 Survey results on the question of employment rights
IPSE's survey (Appendix C) asked how respondents would feel if they were to continue to work on public sector contracts and were required to pay the same tax and National Insurance as an employee, but not have the same employment rights.
A total of 84% thought this was unfair:

- 51% think this is unfair and would challenge their client on it
- 19% think it is unfair and would consider taking legal action against their client
- 14% think it is unfair but would take no action

Only 3% felt this is fair (and would take no action).

The vast majority surveyed felt applying employment taxes without employment rights is unfair and almost one in five would be prepared to take legal action to address the issue. Over half would challenge their client on this point.

10.3 The proposal conflicts with OTS advice
The government appears to be ignoring the findings of the Office of Tax Simplification in its 2015 report on Employment Status:

[19] Off-payroll working in the public sector, HMRC p 21 Published May 2016

"This is a key point that needs to be explored: … there is an almost universal call for rules to apply to both tax and employment rights. That may not be possible given that employment rights follow from employment law and are outside the control of the tax authorities. But there would be huge benefits in harmonised rules and the possibilities need to be explored."[20]

IPSE believe the government should consider ways to harmonise tax and employment status treatment when implementing any reforms. In doing so it must also consider the impact awarding employment rights to workers would have on employers. This will create significant additional costs and burdens for businesses (that had originally intended to engage a contractor with no, or limited, employment rights).

10.4 If the engagement is pre-determined to have characteristics consistent with employment, the role should be filled by an employee, not a PSC being taxed like an employee

If IPSE has understood the proposal correctly, the engaging public sector body will in some cases need to consider whether the engagement will require personal service and whether the worker will be under its supervision, direction and control. This will help it to determine whether the engagement has characteristics of employment, or self-employment. It may also refer to the new online tool to further assist it with this determination.

For new engagements, it will do this before advertising the role, so that it can explain to the PSC whether it will be paid gross, or whether employment deductions will be made at source. For current engagements, it will do this when the PSC is already under contract.

IPSE believes that where the engager determines that the role is inside IR35 - and therefore has characteristics of employment – the public sector body should employ the worker. The proposal to engage a PSC, in full knowledge that the role is more suited to employment is inconsistent. Either it's employment or it isn't.

The disadvantage of this more consistent, and in our opinion more logical, approach, is that where the engager makes the wrong determination (which we believe it frequently will, see section 8 on shifting the liability) it will unnecessarily rob itself of the flexibility, efficiency and specialist skills that PSCs provide (see section 6 on the economic contribution of PSCs and section 7 on costs of implementing the proposal).

11. The online tool

As noted above engagers will be motivated to apply employment taxes to all engagements, for fear of being liable should they make the wrong status determination. This is because IR35 is so complex, engagers will find it very difficult to be certain they have got it right.

The government's solution is the proposed online tool. IPSE does not believe this will work. Similar tools such as the ESI tool and the Business Entity Tests have not worked.

11.1 Previous tools have not worked

The reasons for the failure of previous tools are many and varied but essentially it comes down to the fact the rules around status, and IR35, are complex and open to interpretation. Applying them to real

[20] Office of Tax Simplification, Employment Status report, p.9 Published March 2015

life engagements can only be done subjectively. Generic tools are incapable of generating an accurate determination. We have seen nothing to make us this think this tool will be any different, even after several discussions with HMRC.

11.2 It is not clear who will complete the tool

There is also the question of who will complete the tool. IPSE presumes the tool will be completed by the engager with the responsibility to decide whether IR35 should apply. In many cases this will be an agency.

11.3 Agencies will not have the necessary information to complete the tool

The agency will not have the necessary detailed understanding of the working practices of the engagement to enter the relevant information, as they will not observe the day-to-day interactions between the client and the service provider. The agency will therefore be reliant on information passed to it by the client or service provider. What happens when this information conflicts? What happens when no information is forthcoming? When happens when the working arrangements change over time? What happens when the information is vague or unclear? The answer to all of these questions is that the agency will ignore the tool and apply the new rules, regardless of the actual status of the engagement, in order to avoid liability.

11.4 Hiring managers will not have the necessary knowledge of IR35 to complete the tool

Where the end client is the body with responsibility for determining status (when there is no agency in the chain) we presume it will be the body that will enter information into the tool. However there will still be a question of whether it will have the necessary information. The hiring manager will have the clearest idea of how the relationship between the PSC and the hiring organisation will work, but they will almost certainly have no idea of what IR35 is. How then can they be expected to complete a tool which will determine IR35 status?

11.5 Tax departments will not have the necessary knowledge of the engagement to complete the tool

Perhaps some public sector bodies will have a tax department (many won't) and they may have some IR35 knowledge, but is it realistic to expect them to complete the tool when they are unlikely to have any idea about the nuances of the engagement? Who within the organisation will have the knowledge, experience and authority to bind it to a decision on status that ultimately may cost the organisation a back tax bill?

11.6 If the proposal must be implemented, it should at least be delayed until there is consensus that the tool works

It is clear that this entire proposal rests on the ability of the tool to achieve accurate determinations. However it would seem from the discussions we have had with HMRC so far that this is some way off. It is also clear from the many discussions we've had with other stakeholders that there is little faith in the tool at present.

If the government is intent on pressing ahead with this proposal – which IPSE believes would be a mistake – IPSE recommends implementation of the proposal be postponed until the tool has been developed, introduced and tested on a voluntary basis. Once there is consensus that the tool works, then government could consider mandating its use in the public sector.

12. Complexity

If this proposal is implemented as planned, it will make an already complex part of the tax system even more complex. There will be one set of rules for the public sector, and one set for the private sector. We know the government has an ambition to make tax simpler. IPSE shares that ambition. This proposal will quite obviously make the tax system more complex.

12.1 Complexity for PSCs

It will be commonplace for some PSCs to have to operate both sets of IR35 rules (private and public sector) in the same tax year, or even concurrently.

Engagements that are 'caught' by the new rules will create complexity for the PSC's accounting systems. The PSC will invoice the client but will only receive part of the money owed, as tax and NI will have been deducted. This is further compounded if the engagement is through an agency – how will the PSC and the agency balance their books? How will this work for PSCs and also for their own payroll and tax affairs? Will the PSC get payslips from their clients?

This proposal will create unnecessary bureaucracy and complexity for small businesses.

12.2 Complexity for agencies

For agencies this proposal will make life considerably more complex. Overnight agencies will have to understand IR35, which is inherently complex. They will also have to collect information about the nature of the engagement, the working practices etc. It will be an enormous burden, one which they will be unwilling, perhaps even unable, to take on. This will lead to them declaring the IR35 rules apply to all engagements and deducting employment taxes, but even this will cause complexity.

Some agencies only engage PSCs. They do not operate payroll, and do not have the expertise or the software to calculate, deduct and pay employment taxes. Even those that do will incur significant costs in trying to align procurement and invoice billing systems with HR and payroll systems. These systems are typically standalone and often provided by different suppliers. Software providers are unlikely to be ready for these changes so bespoke system changes would be required to ensure smooth integration which come at significant cost. The typical consultancy fees charged by payroll providers to implement these system changes is £1,000 per day, so the total cost to businesses to implement these system changes will be significant and estimated to be upwards of £10,000 - £30,000 for the average business.

For many agencies, these costs will be prohibitive. Smaller agencies in particular will be impacted. They will choose not to supply to public sector clients. This proposal will damage SMEs in the supply chain and will negatively impact the government's target that 33% of its spending should flow to SMEs by 2020[21].

12.3 Complexity for public sector bodies

Like all organisations, public sector bodies benefit from easy access to specialist skills on a flexible basis. This proposal will act as a barrier to this access. Engaging PSCs will necessarily become more complex as a result of this proposal being implemented.

[21] National Audit Office https://www.nao.org.uk/governments-spending-with-small-and-medium-sized-enterprises/ March 2016

The same problems that agencies face with regard to the alignment of payment systems will impact public sector bodies too.

13. Outstanding questions from the consultation document

In framing this response IPSE has answered many of the questions posed by the proposal. Answers to the specific questions in the consultation document are given below, where appropriate.

Question 1: Are there other easily understood definitions that work better than the FOI Act and the FOI (Scotland) Act?

The FOI definition seems appropriate, but the point is moot as IPSE believes the entire proposal is flawed.

Question 2: Are there any public sector bodies which are not covered by the FOI acts which should be included in the definition for the proposed rules?

IPSE believes the proposal will be damaging to public sector bodies it applies to. We would therefore not recommend that the population of bodies it applies to is increased.

Question 3: Should private companies carrying out public functions for the state be included in this definition? Why?

No. The proposal should apply to as few entities as possible as it will be damaging.

Question 4: Are there any public bodies caught by this definition who would face particular impacts which should be considered?

All public sector bodies that the proposal applies to will be impacted negatively. The more heavily they rely on PSCs to deliver public services, the more negatively impacted they will be.

Question 5: Are rules needed to ensure that engagers have the information they need to make the decision? If so, what should they be?

Public sector bodies should be held liable if the information they provide to agencies is inaccurate or not forthcoming. Public sector bodies should also have a duty to inform agencies they are public sector bodies (it may not always be obvious).

Question 6: How would accounting for the 5% allowance work in practice?

The 5% allowance should be retained. It should work like the tax free personal allowance.

Question 7: Are there business costs specific to PSCs that are covered by the 5% that aren't covered under the usual business expense rules?

This question is oddly phrased. If government is asking 'do PSCs sometimes incur expenses that exceed the 5% allowance?' the answer is yes.

The 'usual business expense rules' will be irrelevant if these new rules are applied, as the gross income will be taxed before expenses are deducted. This is part of the inherent unfairness of the proposal.

There is also a risk that businesses will be unable to build up a reserve, and could end up operating while insolvent. This is because while most businesses are able to pay tax after the tax year has ended, businesses caught by this rule will have to pay tax up front. This will inhibit their ability to build up a reserve. If the business is then out of contract for a while, but still has to pay insurances and accountancy fees, the business could become insolvent.

Question 8: Does the first part of the test work to quickly rule out engagements that are clearly out of scope?

The test which asks whether 20% or more of the contract is for materials is curious. This is because:

- The 20% threshold seems to have come from nowhere.
- Even if materials used make up 20% or more of the contract's value, the engagement could still be IR35 caught, according to case law.
- More commonly there will be a huge number of engagements that are outside IR35 but the use of the materials will make up less than 20% of the contract value.

The 20% test doesn't appear to be useful.

Question 9: Are these the right questions in the right order of priority?

Assuming we are still talking about the first part of the test, as outlined in Diagram 3, page 24, we have no comment on these questions, other than those on the '20%' question above. We comment on the questions in the second part of the test in Q10.

Question 10: Are the questions simple to understand and use?

No further comment.

Question 11: Do the two parts of the test give engagers certainty on day one of the hire?

No. The second question in the first part of the test is 'Is the worker hired through an agency?' If the answer is 'yes' (as it will frequently be) the second part of the test will be completed by the agency.

The agency will not be able to answer the questions in the second part of the test (on personal service and control) as they will not have the relevant information. Only the PSC and the client will know this information. This will result in the agency taking a risk averse approach and applying the rules without properly considering the status of the engagement.

On the second part of the test specifically:

- There should be a third question on mutuality of obligation here, as this is a central pillar of IR35 (along with personal service and control).
- If the engager is able to answer 'no' to any of the three main questions (the third being the one proposed above on mutuality), the engagement is outside IR35. This is not explained in the consultation document. Instead the document suggests that a lack of both the need for personal service and control needs to be established and even then the engagement still needs to get past the online tool. This is not in keeping with the current rules.

The consultation document states that the current employment status rules will be used to determine engagement status:

"To provide greater clarity and certainty HMRC has developed a new simplified process using the current employment status rules which will make it easier to make a decision on an engagement"[22]

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[22] Off-payroll working in the public sector, HMRC, p.22 Published May 2016

If the gateway is to work with current employment status rules, it should run as follows:
Question 1 - Is the worker required to do the work themselves? If the answer is 'no', the engagement is not in scope for the off-payroll rules and the PSC can continue to be paid gross as adequate assurances have been given. If the answer is 'yes', move on to question 2.

Question 2 - Does the engager decide or have the right to decide how the work should be done? If the answer is 'no', the engagement is not in scope for the off-payroll rules and the PSC can continue to be paid gross as adequate assurances have been given. If the answer is 'yes', move on to question 3.

Question 3 – Is the engager obliged to offer the PSC more work once the project has been completed; and would the 'off-payroll' worker be obliged to accept it? If the answer is 'no', the engagement is not in scope for the off-payroll rules and the PSC can continue to be paid gross as adequate assurances have been given. If the answer is 'yes', move on to the online tool.

If the gateway were to work like this it would quickly remove engagements that are not IR35 caught from the assurance process. Instead the gateway proposed will result in the vast majority of engagements being put through the online tool, or having the new rules applied even before the tool is consulted.

Question 12: How can the organisation completing the tests ensure have the information to answer the questions?

It depends which organisations are completing the tests. The PSC and the client will between them have a comprehensive understanding of the engagement. The agency will have very little information. Agencies will take a risk averse approach and apply the rules, without considering status. Public sector clients will often do the same as they will not have even a basic understanding of IR35.

Question 13: How could the new online tool be designed to be simple and straightforward to use?

IPSE does not believe the tool will work. See section 11 of this response for more comment on the online tool. IPSE believes that until the tool has been tested and has industry support, the proposal should not be implemented.

Question 14: Where should the liability for tax and National Insurance (and penalties and interest where appropriate) fall when the rules haven't been applied correctly?

Liability should rest with the PSC, as should the decision on whether IR35 applies to the engagement. See section 9 for more on liability.

Question 15: Should the liability move to the PSC where the PSC has given false information to the engager?

No further comment.

Question 16: What one-off and ongoing costs and burdens do you anticipate will arise as a result of this reform?

The costs of this proposal will be significant. See section 8 – Costs of implementing this proposal.

14. SUMMARY OF IPSE RECOMMENDATIONS

1. The proposal should be abandoned

2. Adopt the Freelancer Limited Company

3. Government should undertake a strategic review of the taxation of income

4. If the government wants the people that work for it to pay employment taxes, it should employ them

Should the Government persist with the proposal, contrary to recommendations 1 – 4 above, we would make the following, further recommendation:

i) Delay implementation of the proposal until there is consensus that the online tool works

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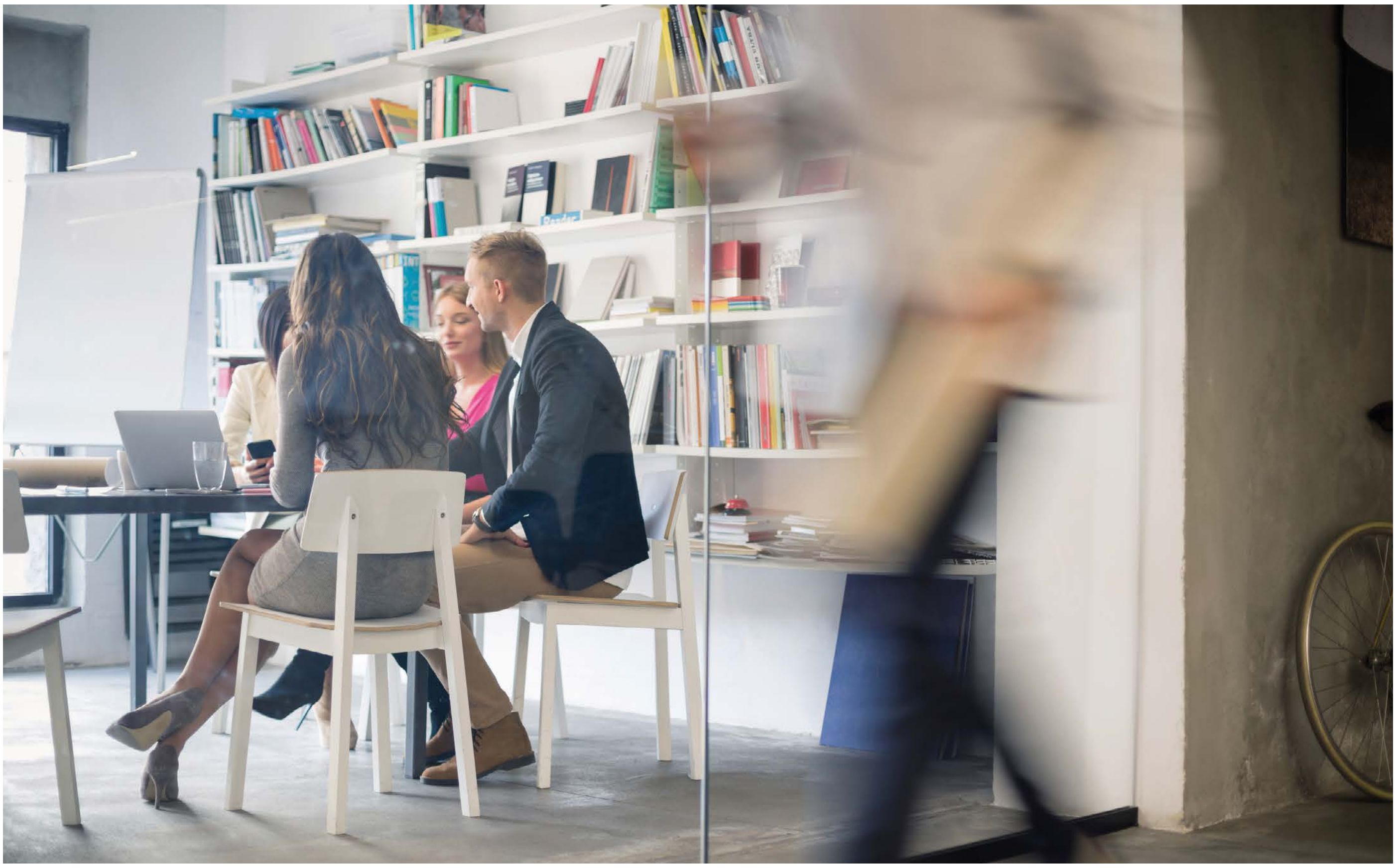
15. Appendix

The Economic Impact of Personal Service Companies

Report

August 2016

www.ipse.co.uk



Oxford Economics

This report is authored by Oxford Economics, a global economic consultancy which was founded in 1981 to provide economic forecasting and modelling to UK companies and financial institutions expanding abroad. Since then, the company has become one of the world's foremost independent global advisory firms, providing reports, forecasts and analytical tools on 200 countries, 100 industrial sectors and over 3,000 cities.

Oxford Economics is a key adviser to corporate, financial and government decision-makers and thought leaders. Their worldwide client base now comprises over 1000 international organisations, including leading multinational companies and financial institutions; key government bodies and trade associations; and top universities, consultancies, and think tanks.

IPSE

This report was commissioned by IPSE, the Association of Independent Professionals and the Self Employed. IPSE is the largest association of independent professionals in the EU, representing over 67,000 freelancers, contractors and consultants from every sector of the economy. It's a not-for-profit organisation owned and run by its members.

We believe that flexibility in the labour market is crucial to Britain's economic success, and dedicate our work to improving the landscape for the freelance way of working through our active and influential voice in government and industry.

IPSE aims to be the principal and definitive source of knowledge about freelancing and self-employment in the UK. We work with leading academic institutions and research agencies to provide empirical evidence about evolving market trends. This research supports our work with government and industry and delivers key market intelligence to help our members with business planning.

Table of Contents

Executive Summary

In 1999 the government introduced IR35 legislation in an attempt to clarify the position of intermediary companies in regulatory and tax terms. Since that time, Personal Service Companies (PSCs) have become an increasingly popular way in which professional freelancers have structured their affairs in order to provide their services to other companies, partly driven by a pressure from clients for freelancers to operate in this way. Under this model, individuals operate as contract workers through the intermediary of an incorporated business.

307,000

PSCs in the UK in 2015

This represents annual growth of 5.5 percent since 2012/13

Over the past 18 months, these kinds of organisations have been subject to intense scrutiny and to a series of regulatory changes either planned or already implemented. These changes are intended to clamp down on instances where an employer/employee relationship is instead structured as a client/contractor one, but also having the effect of threatening to make this form of work less viable for legitimate professional freelancers. Despite such scrutiny, relatively little is understood about PSCs and their role in the economy. In this context, this report offers a timely attempt to shed light on the economic activity of this group of companies.

Number of PSCs in the UK

In 2015, building on HMRC's previous analysis, we estimate that 307,000 PSCs operated across the UK economy. This suggests that the number of PSCs has grown at an average annual rate of 5.5 percent, comfortably outstripping the rate of increase of the overall business population during this period, which was only 3.8 percent.

Direct Contribution

PSCs had a combined turnover of £24.2 billion during 2015 and from these earnings made a direct contribution to UK GDP of £21.3 billion (1.1 percent). Survey evidence shows that the average PSC had an income of £78,800 in 2015 and collectively made an economic contribution to UK GDP that was larger than the whole mining and quarrying industry, or all of the UK civil engineering sector.

£37.9bn

Total contribution to GDP

Of this, £21.3 billion is contributed directly by PSCs' activities

602,000

Total employment supported by PSCs' activities

Nearly half of this, 294,000, comes through the supply chain and consumer spending they support

£4.7bn

Estimated value attributable to the benefits that PSCs provide clients in terms of increased flexibility & reduced risk

This represents 20 percent of their total earnings

Indirect and Induced Contributions

Beyond this direct contribution, a considerable amount of further economic activity was sustained by the everyday purchases of goods and services by PSCs in the operation of these businesses. PSCs sustain additional activity via their procurement expenditure on items such as travel, accommodation, accountancy services and IT equipment. Known as the indirect impact, we estimate that such spending contributed an additional £2.1 billion to UK GDP in 2015.

In addition to earnings and supply chain spending, PSCs support a large amount of consumer spending. The income earned by the individuals operating PSCs and the wages of employees supported along the supply chain sustains a further round of economic activity, as wages are spent throughout the consumer economy, for example in retail and leisure establishments —this is known as the induced effect. This spending contributed a further £14.5 billion to GDP in 2015. Taking the direct, supply chain and consumer spending contributions together, the total economic footprint of PSCs amounted to a substantial £37.9 billion in 2015.

As well as generating economic output, the activities of these kinds of organisations supported 602,000 jobs in the UK economy in 2015. Alongside the 307,000 freelancers working through PSCs, a further 43,000 jobs were sustained in the supply chains of those organisations and an additional 252,000 were supported by the expenditure of associated wage income in the consumer economy.

Productivity

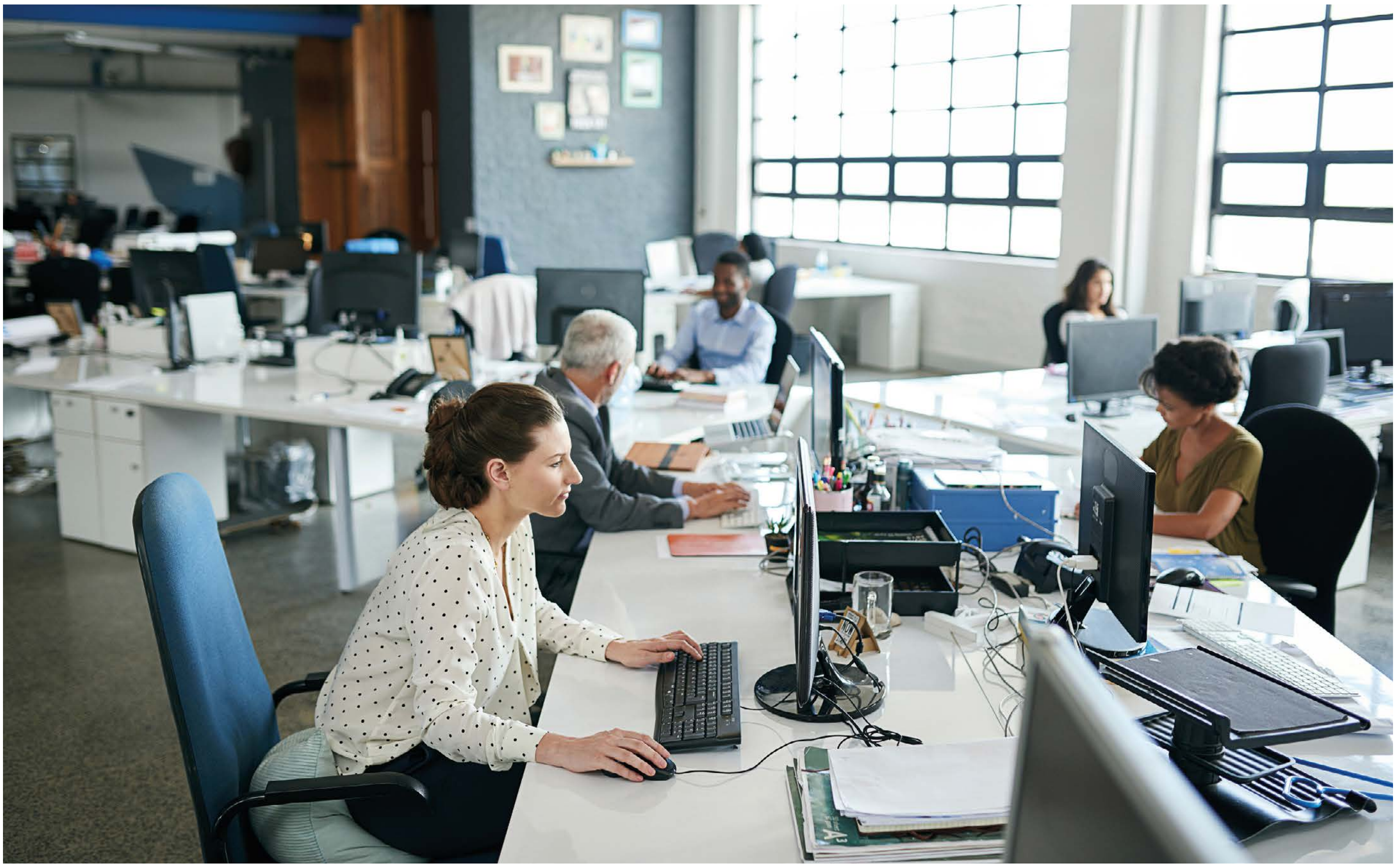
PSCs are very productive relative to other parts of the economy. In 2015 each PSC made an average direct contribution to GDP of £69,400, 30 percent higher than the UK average contribution per worker.

Wider Economic Benefits

The benefits that PSCs bring to the UK economy extend beyond this economic footprint however. Clients engaging freelancers through PSCs are afforded a wide set of benefits, chiefly in terms of enhanced flexibility. The use of PSCs allows clients to adjust the number of workers at their disposal as required by the demand for their goods and services. This offers valuable freedom to organisations and supports the UK economy by ensuring that the UK's finite talent pool is being utilised effectively.

Where clients benefit from flexibility, the individuals operating PSCs bear the risks of irregular working patterns and are compensated through higher earnings. For example, survey evidence from IPSE shows that the average freelancer works for approximately 71 percent of their time, with many unable to secure the ideal number of hours, and sometimes being out of work for weeks or months at a time. In effect, freelancers absorb this risk for clients. The value that this generates to clients is reflected in the higher earnings that contract workers enjoy compared to salaried employees. Our analysis estimates that this premium is equivalent to around 20 percent of PSCs' earnings. Across the whole sector this implies that, in 2015, the benefits that PSCs provide to their clients in terms of increased flexibility and reduced risk amounted to some £4.7 billion.

The research in this report demonstrates both that PSCs have a considerable economic footprint and provide a broader set of benefits to their clients and the wider economy. The relative merits of regulatory reforms that might affect the viability of this operational model should be considered in the light of this value.



1. Introduction

Flexibility and adaptability are much lauded features of the UK labour market, which is able to respond to economic pressures and adjusting demand more easily than many other European economies. This is reflected in companies demanding flexibility on the part of workers, and is evidenced in the rapid growth in the number of people offering their services as freelancers. For example, a report by Kingston University[1] and subsequently updated data demonstrates that the number of freelancers grew at an annual rate of 3.7 percent between 2005 and 2015, nearly three times the 1.3 percent growth rate in self-employment.

However, with a changing working landscape, this shift has also been accompanied by an increasing government focus on the regulatory and tax environment within which these contractors operate. In particular there has been an emphasis on the group of freelancers working through companies known as Personal Service Companies (PSCs). These are individuals who operate as contract workers through an intermediary company, usually set up as an individual or within a partnership.

In recent years the regulatory landscape confronting PSCs has evolved rapidly with the government having implemented or announced that it is considering a number of reforms. These include:

- Restriction of tax relief made for travel and subsistence costs; [2]
- A consultation into the effectiveness of the existing IR35 legislation, creating uncertainty over the government's policy direction, with the possibility for a range of different policies to be tabled;[3] and
- A government proposal to increase the responsibilities for public sector bodies to monitor the tax liabilities of contract workers that they use.[4]

All of these changes risk increasing the financial costs faced by PSCs as well as introducing a significant degree of regulatory complexity for PSCs to follow. Such disruptions have the potential to affect the viability of operating as a PSC for many individuals, threatening the contribution that they make to the UK economy.

Despite the recent degree of policy scrutiny, relatively little is known about this form of freelancer, what distinguishes them or their contribution to the UK economy. This report seeks to plug this gap in the literature by providing a comprehensive assessment of the economic contribution made by PSCs during 2015. This analysis is then extended to assess the distinct benefits that this structure offers to both the organisations who hire them and the economy as a whole.

[1] J Kitching and D Smallbone, "Exploring the UK Freelance Workforce, 2011" (Report, 2012).

[2] HM Treasury, "Spending Review and Autumn Statement 2015" (Policy document, 2015).

[3] HM Revenue & Customs, "Intermediaries Legislation (IR35): discussion document" (Technical note, HM Revenue & Customs, 2015).

[4] HM Revenue & Customs, "Off-payroll working in the public sector: reforming the intermediaries legislation" (Consultation Document, 2016).

2. The Prevalence of PSCs

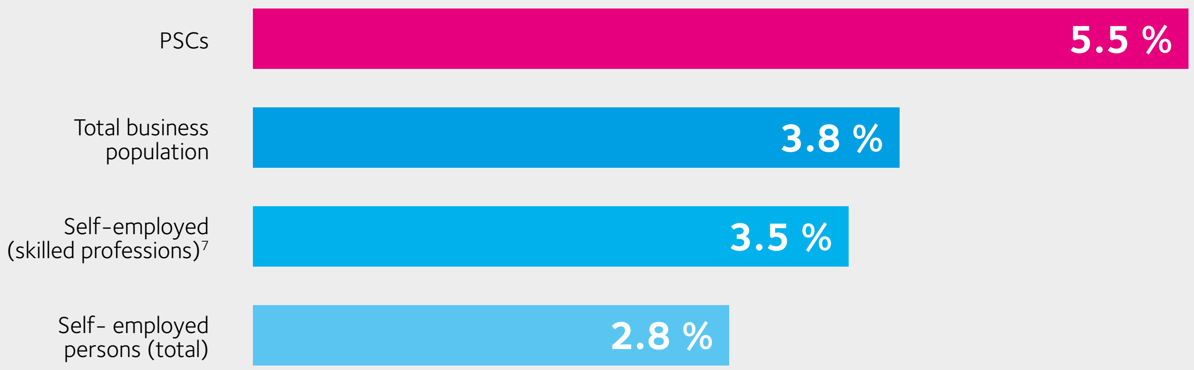
Despite their significant role in the UK economy and the increasing policy focus on PSCs, the evidence on them and their prevalence among UK freelancers is very limited. Whilst no legal definition of PSCs exists,[5] one definition which this report focusses on was made by the House of Lords Select Committee, which makes an attempt to define PSCs, stating:

"It is understood generally to mean a limited company, the sole or main shareholder of which is also its director, who, instead of working directly for clients, or taking up employment with other businesses, operates through his company." [6]

The most recent official analysis of PSCs estimated that there were 265,000 active in the 2012/13 financial year. Building on this research, we estimate that there were 307,000 PSCs active in 2015.

Our results point to robust growth in the number of PSCs over the past two years, a reflection of strong demand for the flexible working patterns offered by these organisations. Between the 2012/13 financial year and the 2015 calendar year, the number of PSCs increased by 16 percent, representing annual growth rate of 5.5 percent. As Fig.1 demonstrates, this is approximately double the growth in self-employment and is comfortably higher than growth in both skilled self-employment and the UK's overall business population.

Fig. 1. Average annual growth rates of PSCs and comparisons



Source: Oxford Economics, ONS

Estimating the Number of PSCs

As well as there being no precise definition of PSCs available, this is not a group that is identified in national statistics data. Instead, the only source of an estimate for the number of active PSCs comes from a 2012/13 report by the HMRC. This report found that there were a total of 265,000 active PSCs in the UK. [8]

As there was no update to the 2012/13 estimate made by HMRC, our analysis instead extrapolated the existing figure based on available information that is indicative of the growth over that period of time.

Business Population Estimates produced by the Department for Business, Innovation and Skills were used to identify the growth in zero-employee incorporated firms since 2012/13, alongside quarterly data on self-employment to make the adjustment from financial-year to calendar-year.

The growth estimates that this generated were compared to analysis of the freelance sector in the 2012 and 2015 Kingston University reports, revealing a nearly identical growth (16.1 percent compared to 16.0 percent).[9] [10] The estimate generated from the analysis of zero-employee was therefore considered robust, and preferred given that it focussed on a narrower number of businesses, of which PSCs are a component.

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[5] Despite the lack of a legal definition, PSCs should be viewed as a subset of the wider pool of skilled professional freelancers, which is in turn a subset of the self-employed population.

[6] House of Lords Select Committee on Personal Service Companies, "Personal Service Companies ", in UK Parliament <http://www.publications.parliament.uk/pa/ld201314/ldselect/ldpersonal/160/16004.htm#a1> [accessed 20 May 2016]

[7] Skilled professions are defined as those in occupations covered by Standard Occupation Classification (SOC) codes 1 to 3.

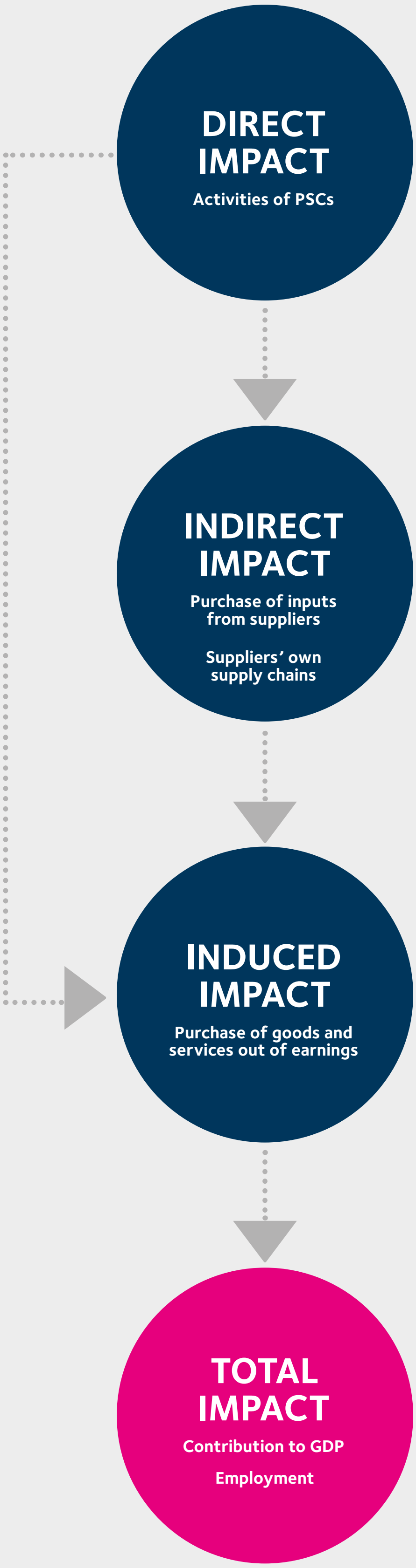
[8] HM Revenue & Customs, "Intermediaries Legislation (IR35): discussion document" (Technical note, HM Revenue & Customs, 2015). As part of the study, attempts were made to source a more recent figure from HMRC. However, details about any more recent research and the methodology used in the original estimate were not made available.

[9] J Kitching and D Smallbone, "Exploring the UK Freelance Workforce, 2011" (Report, 2012).

[10] J Kitching, "Exploring the UK Freelance Workforce in 2015" (Report, 2016).

3. Economic Impact

Fig. 2. The economic impact framework



3.1 The Economic Impact Framework

In evaluating the contribution that PSCs make we adopted a conventional economic impact framework. This approach establishes the economic contribution that these organisations make by looking at the range of impacts that their activities have on different individuals and organisations. This presents a more comprehensive view than the number of people operating in PSCs or their turnover can demonstrate in isolation.

The modelling approach quantifies economic impacts through three channels:

- **Direct effects** – This is the economic contribution that PSCs make through their own activities, including their earnings or profits, and their tax contributions;
- **Indirect effects** – PSCs purchase goods and services from other businesses as part of their day-to-day operations. Such procurement supports a further stream of economic activity; and
- **Induced effect** – As freelancers working within PSCs and the employees of suppliers consume out of their earnings.

This process is illustrated in Fig. 2. We measure these effects in terms of the contribution of PSCs to GDP and employment.

3.2 Total Earnings

The primary contribution that PSCs make to GDP comes through the value they generate for their clients, as reflected in their total remuneration. Our analysis of survey data provided by IPSE suggests that PSCs had an average annual turnover of £78,800 in 2015. Scaling up across the estimated 307,000 PSCs, this equates to a total earnings of £24.2 billion.

Benchmarking our results

Relative to alternative analysis of freelancers, PSCs' average incomes are significantly higher.

The 2015 Kingston University report utilised data on the turnover of businesses with zero employees from the UK Business Population Estimates. Using this they estimated that the 1.8 million freelancers had a collective turnover of at least £109 billion. This equates to £60,600 per freelancer, meaning that average PSC incomes were 30 percent higher.[11]

Analysis for IPSE by Oxford Economics in 2009 considered the output of the whole freelancing sector by analysing earnings in different income groups using data from the Annual Survey of Hours and Earnings in addition to a premium that they earned based on data on the IT industry.[12] This valued the output of the sector at £82.2 billion across the 1.59 million freelancers active at that time, or £51,600 per individual. After inflating this to 2015 prices and adjusting for the increased productivity over this time the sales generated by freelancers in 2009, PSCs' incomes were still nearly a third higher than this.[13]

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[11] J Kitching, "Exploring the UK Freelance Workforce in 2015" (Report, 2016).

[12] Oxford Economics, "The economic costs of IR35" (Report, 2009).

[13] Analysis of ONS data on the GDP deflator shows that inflation has been around 12.8% with productivity having grown by 2.5%. Inflating the 2008 figure by this much leaves PSCs operating with turnover around 32% higher.

3.3 Direct Contribution

The direct contribution that PSCs made to UK GDP in 2015 is estimated to have been worth £21.3 billion. The contribution that PSCs made to GDP directly in 2015 was significant relative to certain other sectors. As Fig. 3 demonstrates, substantial industries such as civil engineering and the manufacture of transport equipment are of a comparable size.

Freelancers working through PSCs provide their clients with their own labour, without any additional employees of their own. The direct employment supported by PSCs' activities was therefore equal to the number that were active, resulting in a direct employment of 307,000 in 2015.

Fig. 3. Direct contribution to GDP of PSCs and comparator sectors

£25.8bn	£23.8bn	£22.4bn	£21.3bn	£19.8bn	£18.6bn
Arts, entertainment & recreation	Electricity & gas production	Transport equipment manufacturing	Personal Service Companies	Civil engineering	Mining & quarrying

GVA, £ billions

Source: Oxford Economics, ONS

3.4 Indirect and Induced Contribution

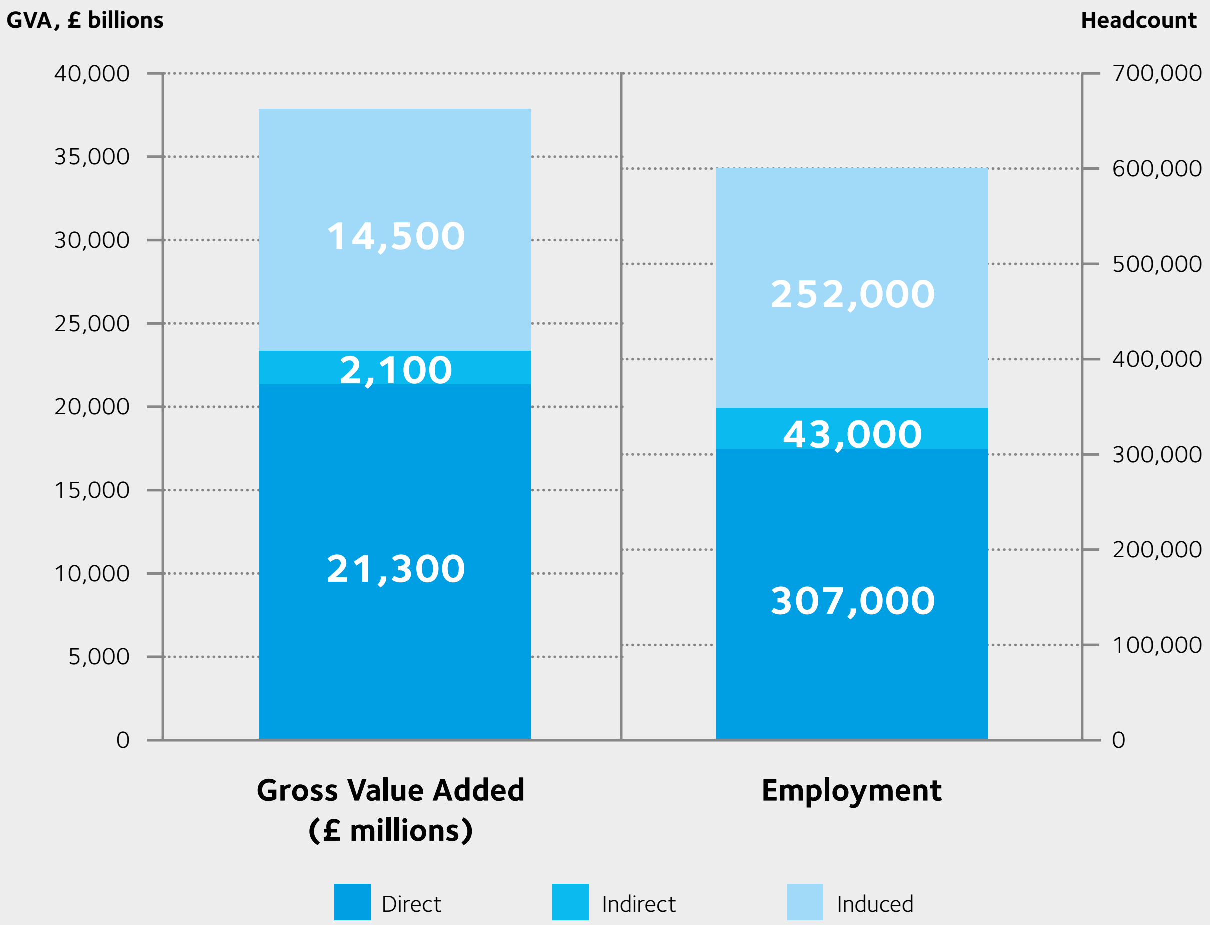
The indirect contribution that PSCs make to GDP totalled £2.1 billion. This reflects the relatively moderate reliance that PSCs have on purchases of goods and services from other businesses.

In contrast to this, a substantial £14.5billion of GDP is supported through the induced effect as PSCs make purchases in the consumer economy from their significant income. The total contribution that PSCs made to UK GDP therefore stood at £37.9 billion in 2015.

The activity that PSCs generate within their supply chains means that PSCs supported a further 43,000 jobs indirectly. The large induced impact resulted in the employment of a further 252,000 individuals. The total employment supported by PSCs in 2015 was therefore 602,000.

As Fig. 4 illustrates, the induced impact of consumer spending is much larger than the indirect supply chain effect. This highlights the significant impact coming from PSCs' spending out of their earnings. Overall, the activity of each PSC, in 2015, sustained approximately one extra job through the combined indirect and induced effects elsewhere in the economy.

Fig.4. Breakdown of contributions of PSCS to GDP and employment



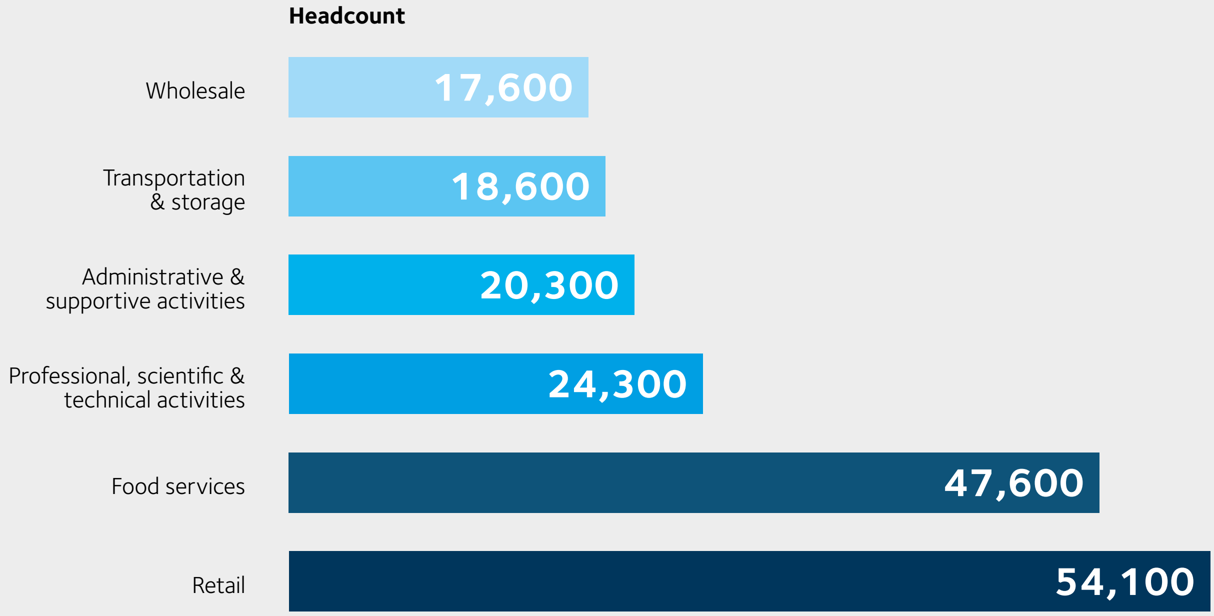
Source : Oxford Economics

3.5 Impact on Different Industries

One of the most noticeable characteristics of PSCs identified in this analysis is the large impact that they have on the economy through their consumer spending. Reflected in a high induced effect, this means that, whilst their reliance on their supply chain might be more limited than for many businesses, a large degree of economic output is generated across the economy as individuals consume goods and services out of their income.

As Fig. 5 demonstrates, the implication of this imbalance is that the largest beneficiaries from the combined indirect and induced effects are consumer-facing industries such as retail and catering. Here, an estimated 54,100 and 47,600 jobs were supported respectively.

Fig. 5. Total indirect and induced employment supported by PSCs

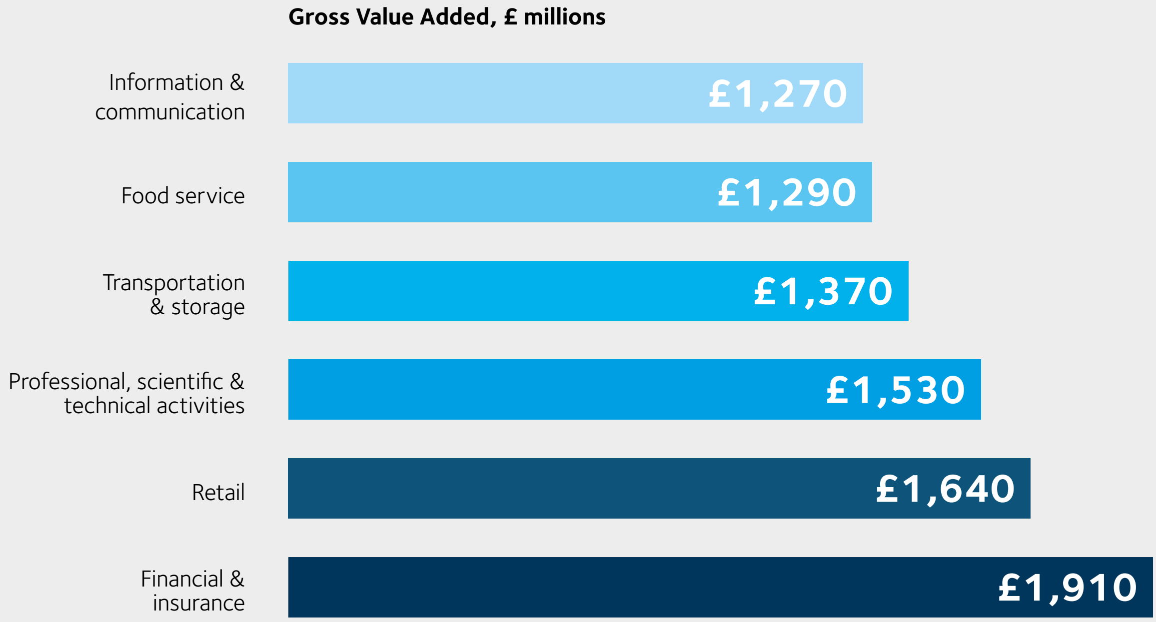


Source: Oxford Economics

The contribution to GDP that PSCs support was highest for the finance and insurance industry, worth £1.9 billion, as shown in Fig. 6. The majority of this was again from the induced effect, which was also key in driving £1.6 billion of activity in the retail sector and £1.5 billion in professional, scientific and technical services.

The purchases that support this marked induced effect will also generate valuable tax revenues, primarily in the form of VAT attributable to freelancers' own purchases.

Fig. 6. Total indirect and induced GDP supported by PSCs



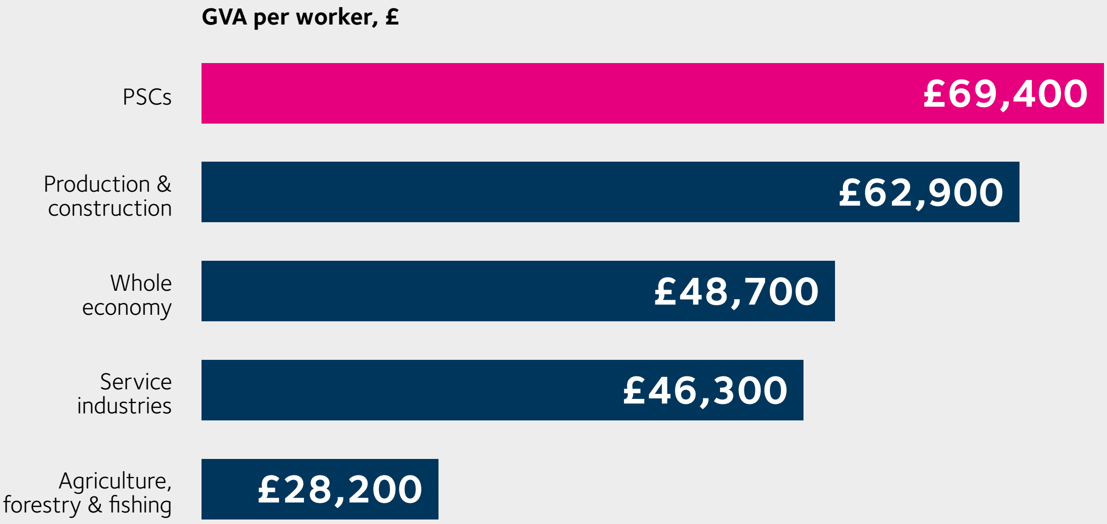
Source: Oxford Economics

3.6 Productivity of PSCs

PSCs' direct contribution to GDP averaged £69,400 per worker in 2015. As Fig. 7 demonstrates, this compared to a total of £48,700 per worker across the economy as a whole. As such, the productivity of PSCs was 30 percent higher than the economy-wide average.

It was also larger than other industry groupings, with only the combined production and construction industries having productivity within 10 percent of that of PSCs.

Fig. 7. Productivity of PSCs in context



Source: Oxford Economics, ONS

4. Wider Economic Benefits

The robust growth in the number of PSCs outlined earlier in this report demonstrates the strong demand that clients have for individuals working in this capacity. This is supported by direct evidence on the preference some clients have for PSCs, identified by the House of Lords Select Committee on PSCs. This references a number of major recruiters of freelancers who either favoured or insisted on freelancers offering the limited liability that PSCs provide.[14]

Firms opt to engage freelance workers for a number of reasons. One of the key benefits that freelancers can offer to clients is greater flexibility. This boosts the ease and speed with which firms can adjust the size of their workforce, enabling them to more precisely match their output to demand.

Analysis of international survey evidence in one study shows a broad consensus around the benefits that employers gain from flexible working patterns. It reported that 83 percent of businesses of various forms reported productivity benefits from flexible working patterns.[15] This study also explored how technological advances are making it more viable for firms to engage freelance labour.

In certain sectors, the ability to engage freelance contractors is absolutely vital. In the UK construction sector, for example, managers report that they "found it hard to conceive of how the industry would operate without the freelance labour market".[16] The evidence also suggests that productivity gains are made across a range of industries as a result of freelance labour through increased specialisation and reduced costs when demand falls as fewer permanent staff are required.[17] By allowing firms to scale their workforce up or down quickly, freelancers support the opportunities for entrepreneurship among their clients.

However, by doing this, freelancers incur the risk of downtime themselves. Survey evidence on freelance work patterns shows that through 2015 freelancers were in work an average of 71 percent of the time.[18] This amount of time that freelancers can expect to be out of work on average is significantly higher than the average time out of work endured by salaried workers.[19] This demonstrates the greater degree of risk that is taken by individuals working through a PSC. Through doing so, they help to alleviate some of the costs that clients incur from periods of low demand.

Clients therefore operate significantly more efficiently as a result of employing PSCs. Quantifying the benefit of this enhanced flexibility is challenging but an indicative value can be gauged by the premium that firms are prepared to pay PSCs over salaried workers.

The more temporary and often specialist work done by freelancers working through PSCs makes such a comparison problematic. Indeed there is no data source which directly compares the earnings of the two in a strictly comparable manner. However, some evidence does exist based on a recent survey of earning patterns in the IT sector.

Analysis of this data revealed that the hourly earnings of contract workers are 20 percent higher than like-for-like employees. Assuming that this relationship is representative of the sector would suggest that, of the £24.2 billion of gross earnings raised by PSCs in 2015, £4.7 billion is value attributable to the specific benefits provided by their freelance status.

5. Conclusion

PSCs play a distinct role in providing labour for organisations across the UK economy. As the demand for a skilled and flexible workforce has increased, the presence of PSCs has risen substantially. Moreover, it seems likely that such trends will continue in the near future.

The results of our economic impact modelling illustrate that this group of firms already sustain a considerable level of economic activity across the economy. In total, PSCs support nearly £40 billion in GDP and over 600,000 jobs.

Moreover, PSCs offer more to their clients than just a source of skilled labour. The extra benefits that clients accrue from this form of work are reflected in the premium that they are willing to pay when employing them. They also take on board significant risk that is not common among salaried professions, absorbing some of the risk of downtime that their clients face.

This report has explored a range of reasons that PSCs should be regarded as a valuable component of the UK economy. As the way that the government regulates and taxes PSCs and their clients is brought into focus, recognising this value is an important part of the process of reform.

[14] House of Lords Select Commitee on Personal Service Companies, "First Report" (Report, 2014), Ch. 2.

[15] Vodafone, "Vodafone gloval survey reveals rapid adoption of flexible working" <http://www.vodafone.com/content/index/media/vodafone-group-releases/2016/flexible-working-survey.html#> [accessed 03 May 2016]

[16] A. Burke, "The Entrepreneurship Enabling Role of Freelancers: Theory with Evidence from the Construction Industry", International Review of Entrepreneurship 9(3), Report (2011).

[17] A. Burke, "The Role of Freelancers in the 21st Century British Economy" (Report, 2012).

[18] Estimates made using findings in the IPSE Freelancer Confidence Index.

[19] The most comparable statistics for the wider economy is underemployment, which covers all involuntary time spent unemployed or working fewer hours than desired. This averaged 6.5 percent through 2015 according to the Bell and Blanchflower underemployment index developed for the Work Foundation. Time out of work is therefore quite significantly higher given the 29 percent of PSCs with a similar type of underemployment.

6. Appendix: Methodology

Producing this report relied on a range of analytical techniques and data sources. For the elements of this methodology not already outlined in this report, this section details the processes used and rationale behind them.

PSC Earnings

In order to estimate the annual earnings of PSCs our analysis utilised evidence from the surveys of freelancers' activities in the Freelancer Confidence Index (FCI). This gave a breakdown of the day rates and typical number of days worked by IPSE members and other freelancers per quarter. This allowed estimates of PSC earnings to be made, with these scaled up to quantify the whole sector's output.

Economic Impact

Their expenses were assessed using the latest edition of the FCI, with their direct contribution to GDP measured as their earnings, minus these purchases. Retained post-tax earnings were then estimated based on the nature of the tax structure typical of this type of company, utilising the income tax allowances, corporation tax rates and dividend tax structures applicable given the average PSCs' income levels.

Analysing the economic activity in firms' supply chains used the 2010 UK Input-Output (IO) table, from the ONS. This indirect contribution was evaluated based on the purchases of goods and services that they made, with the IO table used to map the full supply chain and estimate the contribution to GDP based on the relationship between Gross Output and Gross Value Added (GVA) in each sector. Employment was estimated based on the productivity implied by ONS data on the employment and GVA of each sector.

The induced effect was analysed based on the consumption of PSCs implied by their post-tax earnings, having accounted for the level of savings that is common across private individuals. The IO table was then again utilised, with the same process outlined above.

Together, this allowed us to generate estimates for the economic contribution for the contributions to GDP that PSCs made through the direct, indirect and induced effects.

Analysing Contract Wage Premium

Alongside the analysis of the impact that PSCs' activities have on firms that they make purchases from and the supply chains that these purchases support, we also consider the unique value that employers gain from the labour they supply.

Data on the different wages offered to contract and salaried workers is very limited. As a result this analysis focussed on data for professionals in IT professions, for which we were able to access robust statistics for 2011 from the Contractor UK Market Report.

The equivalent hourly earnings available for permanent staff were taken from the Annual Survey of Hours and Earnings from the ONS. People working in the 'computer programming, consultancy and related activities' industry and people in 'information technology and telecommunications professions' were used. The total costs that businesses would face were estimates based on Eurostat data on labour costs levels for the UK Information and Communication industry. Having scaled up the costs to account for this, we estimate that there was an average additional cost of employing a contract worker of 19.6 percent.

More up-to-date data for 2015 was available through Contract Eye. However, this considered only advertised roles, rather than the wages of all individuals in work, in addition to focussing on a very narrow part of the sector. We considered this to be an exaggeration of the likely average wage. As a result, this indicated a wage level that was higher than the 2011 data to an unrealistic degree.

The Economic Impact of Personal Service Companies in the Public Sector

August 2016

www.ipse.co.uk

Oxford Economics

This report is authored by Oxford Economics, a global economic consultancy which was founded in 1981 to provide economic forecasting and modelling to UK companies and financial institutions expanding abroad. Since then, the company has become one of the world's foremost independent global advisory firms, providing reports, forecasts and analytical tools on 200 countries, 100 industrial sectors and over 3,000 cities.

Oxford Economics is a key adviser to corporate, financial and government decision-makers and thought leaders. Their worldwide client base now comprises over 1000 international organisations, including leading multinational companies and financial institutions; key government bodies and trade associations; and top universities, consultancies, and think tanks.

IPSE

This report was commissioned by IPSE, the Association of Independent Professionals and the Self Employed. IPSE is the largest association of independent professionals in the EU, representing over 67,000 freelancers, contractors and consultants from every sector of the economy. It's a not-for-profit organisation owned and run by its members.

We believe that flexibility in the labour market is crucial to Britain's economic success, and dedicate our work to improving the landscape for the freelance way of working through our active and influential voice in government and industry.

IPSE aims to be the principal and definitive source of knowledge about freelancing and self-employment in the UK. We work with leading academic institutions and research agencies to provide empirical evidence about evolving market trends. This research supports our work with government and industry and delivers key market intelligence to help our members with business planning.

Introduction

In early 2016, the UK government outlined its proposals to reform the way that public sector bodies organise the tax activities of contractors who work for them[1]. Contractors affected will be those who operate through intermediaries (off-payroll), known as Personal Service Companies (PSCs), and this latest move is just one of a number of policy changes related to them. The risk is that faced with higher taxes, contractors will be less incentivised to work in the public sector, undermining its capacity to deliver or driving up costs.

Despite their significant role in the UK economy and the increasing policy focus on PSCs, the evidence on them and their prevalence among UK freelancers is very limited. Whilst no legal definition of PSCs exists[2], one definition which this report focusses on was made by the House of Lords Select Committee, which makes an attempt to define PSCs, stating:

> *"It is understood generally to mean a limited company, the sole or main shareholder of which is also its director, who, instead of working directly for clients, or taking up employment with other businesses, operates through his company."* [3]

The government's consultation document estimates that a total of 26,000 PSCs will be affected by the proposed changes, slightly more than eight percent of all active PSCs. This report explores the contribution that these 26,000 PSCs made to the UK economy in 2015. In doing so it builds upon previous analysis into the economic impact of all PSCs conducted by Oxford Economics for IPSE earlier in 2016. This analysis gives important context to the proposed policy changes, illuminating the number of people who will be directly affected and the potential scale of disruption that may result for both these individuals themselves and the organisations for whom they deliver vital services.

The Economic Impact Framework

The results presented in this report were calculated using a conventional economic impact framework that quantified the contribution to gross domestic product (GDP) and employment made by PSCs through three different channels of economic impact.

DIRECT EFFECT:
This is the economic contribution that PSCs make through their own activities, including their earnings or profits, and their tax contributions.

INDIRECT EFFECT:
PSCs purchase goods and services from other businesses as part of their day-to-day operations. Such procurement supports a further stream of economic activity.

INDUCED EFFECT:
A third channel of activity is generated when freelancers working within PSCs and those employed in their supply chains spend their wages in the wider consumer economy.

[1] HM Revenue & Customs, "Off-payroll working in the public sector: Reform of the intermediaries legislation" (Consultation document, 2016).[3] House of Lords Select Committee on Personal Service Companies, "Personal Service Companies ", in UK Parliament <http://www.publications.parliament.uk/pa/ld201314/ldselect/ldpersonal/160/16004.htm#a1> [accessed 20 May 2016]

[2] Despite the lack of a legal definition, PSCs should be viewed as a subset of the wider pool of skilled professional freelancers, which is in turn a subset of the self-employed population

[3] House of Lords Select Committee on Personal Service Companies, "Personal Service Companies ", in UK Parliament <http://www.publications.parliament.uk/pa/ld201314/ldselect/ldpersonal/160/16004.htm#a1> [accessed 20 May 2016]

The Economic Impact of Personal Service Companies (PSCs) in the Public Sector

PSC: "It is understood generally to mean a limited company, the sole or main shareholder of which is also its director, who, instead of working directly for clients, or taking up employment with other businesses, operates through his company."

House of Lords Select Committee

Number of PSCs operating in the public sector

26,000 PSCs

This is a subset of the 307,000 PSCs operating in the UK

Public sector PSCs make an average direct contribution to GDP that is **8%** higher than that of the wider pool of PSCs

Economic impact

DIRECT IMPACT
£1.9bn
Activities of PSCs

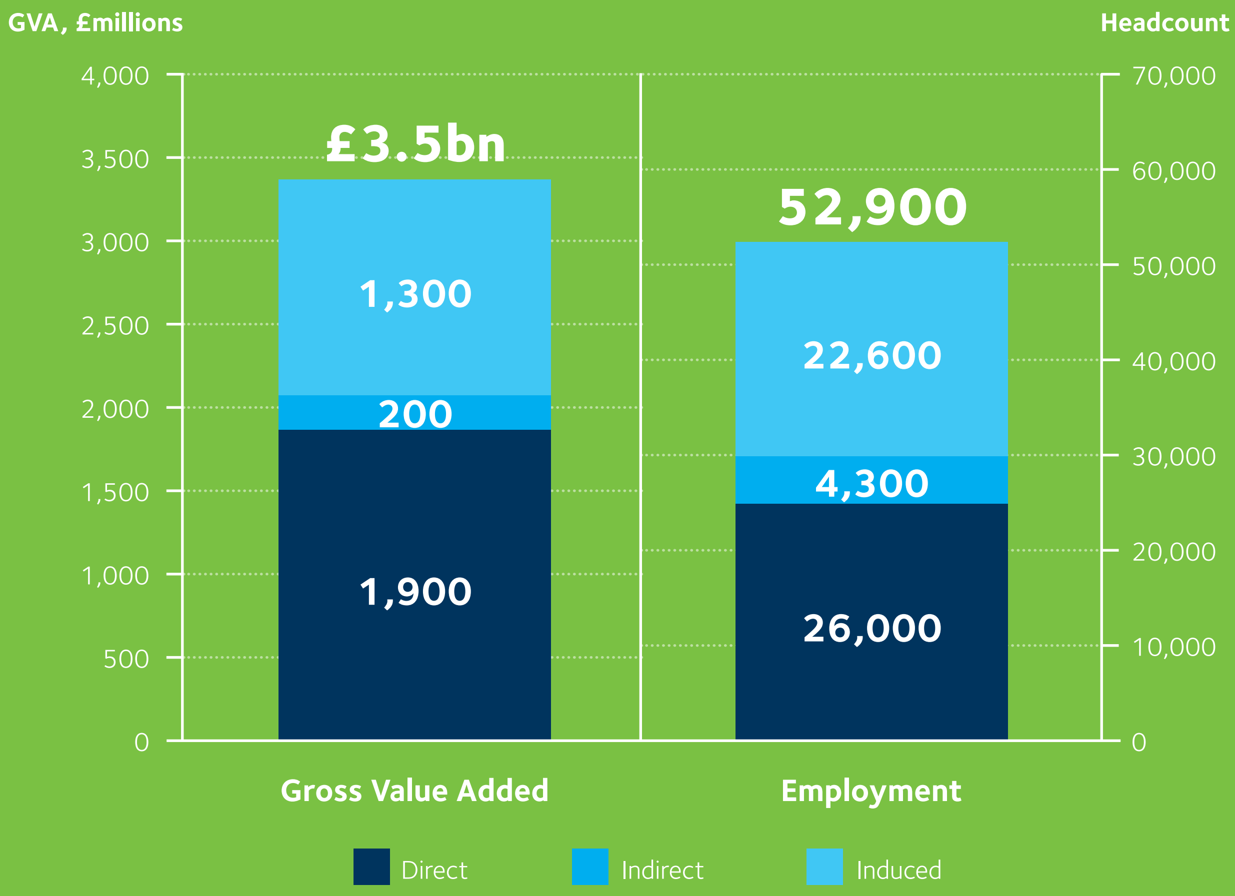
INDIRECT IMPACT
£200m
Purchase of inputs from suppliers

Suppliers' own supply chains

INDUCED IMPACT
£1.3bn
Purchase of goods and services out of earnings

TOTAL IMPACT
£3.5bn
Contribution to GDP

Contributions of public sector PSCs to GDP and employment



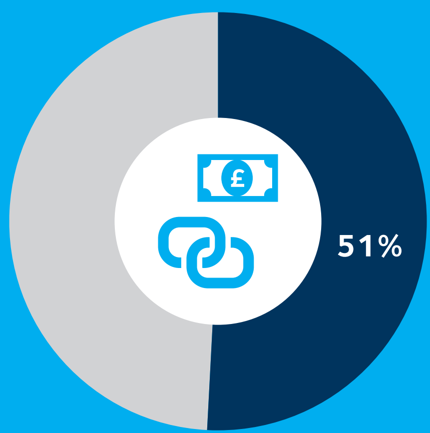
Contribution to employment

52,900 jobs

Total employment supported by PSCs working in the public sector in 2015

51% of this (26,900 jobs)

is employment generated through their supply chain or induced consumer spending



Economic Impact

26,000

The number of PSCs operating in the UK public sector

The average annual income of the 26,000 PSCs who worked in the public sector in 2015, and who would be affected by the policy changes, was £84,300. In total, they turned over in excess of £2.2 billion.

The direct contribution to UK GDP that PSCs made from these revenues was worth a total of £1.9 billion. This is a sizeable contribution. For example, it means that the direct economic output of this group of PSCs in 2015 was comparable with that of the UK's textiles or oil refining industry.

Further, through their supply chains these PSCs supported an additional £200 million in GDP contributions, as well as another with £1.3 billion generated through wage-related expenditure. Together, the total economic contribution of this sub-group of PSCs was worth £3.5 billion to the UK economy in 2015.

£2.2bn

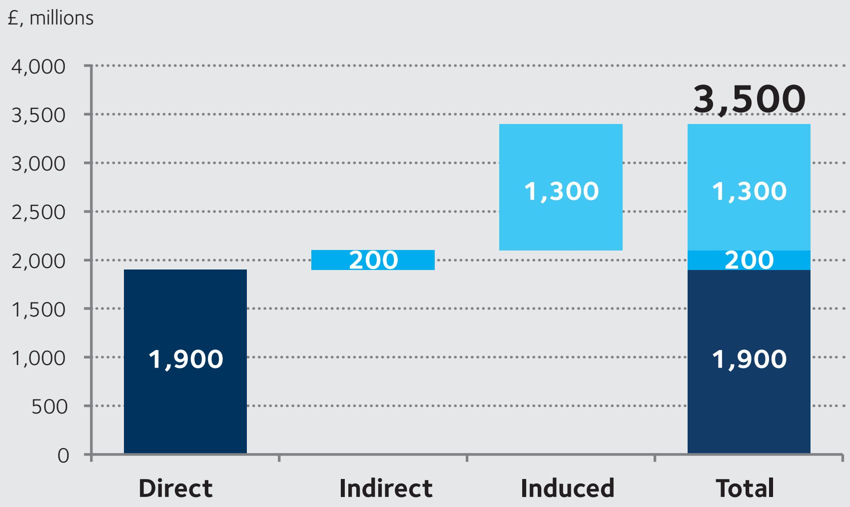
The total turnover of public sector PSCs in 2015

£3.5 bn

The total economic impact of affected PSCs working in the public sector in 2015

Of this, £1.9 billion was produced directly by PSCs

Fig. 1: Contribution to GDP made by affected PSCs in 2015



Source: Oxford Economics

Numbers may not sum to totals due to rounding

52,900 jobs

The total employment supported by affected PSCs working in the public sector in 2015

Employment Supported

As well as the GDP impact, the activities of PSCs working in the public sector, and the wider economic footprint that rippled out from this, also supported a large number of jobs in the economy.

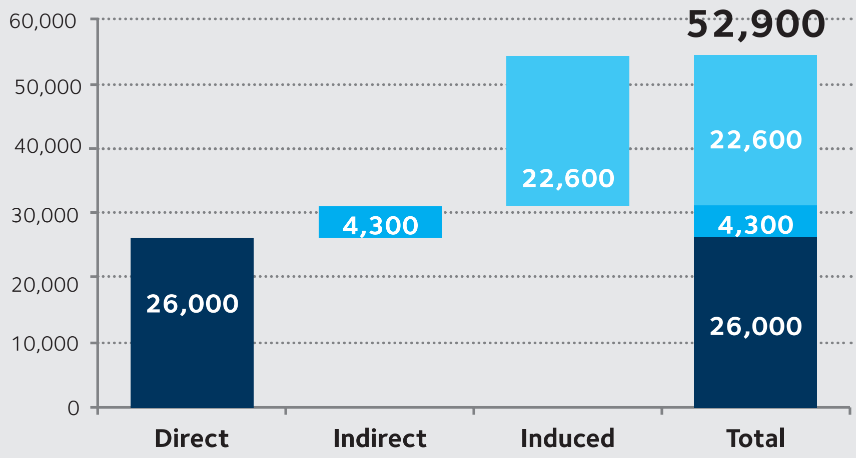
The direct employment sustained by affected PSCs' activities comes from their own employment, standing at 26,000 in 2015.

Indirectly, through their supply chains, PSCs support a further 4,300 jobs and a further 22,600 were sustained through the consumer expenditure that PSCs support. In total, PSCs therefore supported 52,900 jobs in in 2015.

26,900 jobs

Employment generated through PSCs' supply chain or induced consumer spending, more than half the total

Fig. 2: Employment supported by affected PSCs in 2015



Source: Oxford Economics

Numbers may not sum to totals due to rounding

The activity of each PSC in the public sector in 2015 sustained approximately

1 extra job

Characteristics of Public Sector PSCs

PSCs bring additional benefits to the UK economy through their structural makeup. For example, they are highly productive and highly flexible—both of which offer substantial benefits to the public sector organisations that engage them.

Among the 26,000 who work in the public sector, average earnings in 2015 were slightly higher than that of the wider pool of PSCs. A significant reason for this is that they spent less time out of work—25 percent compared to 29 percent across all PSCs. This is reflected in public sector focused PSCs having an average direct contribution to GDP that is eight percent higher than that of the wider pool of PSCs.

This group of PSCs have an economic footprint large enough that each contractor produces one additional job in the economy through the indirect and induced impacts. A key reason for this is that this group of companies provide their services to bodies within the UK, meaning that their expenses are expected to be spent domestically, rather than leaking as they might with international clients.

Together, the footprint of the group of PCSs that will be affected by these reforms to public sector contracts is therefore large. Recognising this is crucial when considering these policy changes.

Methodology

The analysis conducted in this report mirrors the approach taken in a study into the footprint of all PSCs, produced by Oxford Economics earlier in 2016 for IPSE. Again, we analyse PSCs' impacts through their supply chain and the consumption expenditure that they support using an input-output framework. However, some changes were required in order to focus on PSCs operating in the public sector. This brief methodological summary outlines these changes.

The different nature of the clients that these PSCs work for means that one of the most important change in the analysis was the differences in their incomes and expenses. We again utilised the Freelancer Confidence Index, with a focus on respondents who provide services to public sector bodies either directly or through a private sector body (e.g. an agency).

In addition, whereas the initial report assumed that a portion of expenses were leaked abroad due to purchases of foreign goods when working on international contracts, it is assumed that this is not the case for the companies in this report. This leakage was therefore assumed to be zero.

Together these changes meant that the modelling used was tailored to the specific characteristics of PSCs engaged by public sector bodies that will be affected by these reforms.

Changes to IR35 in the public sector
How will it affect independent professionals?

Introduction

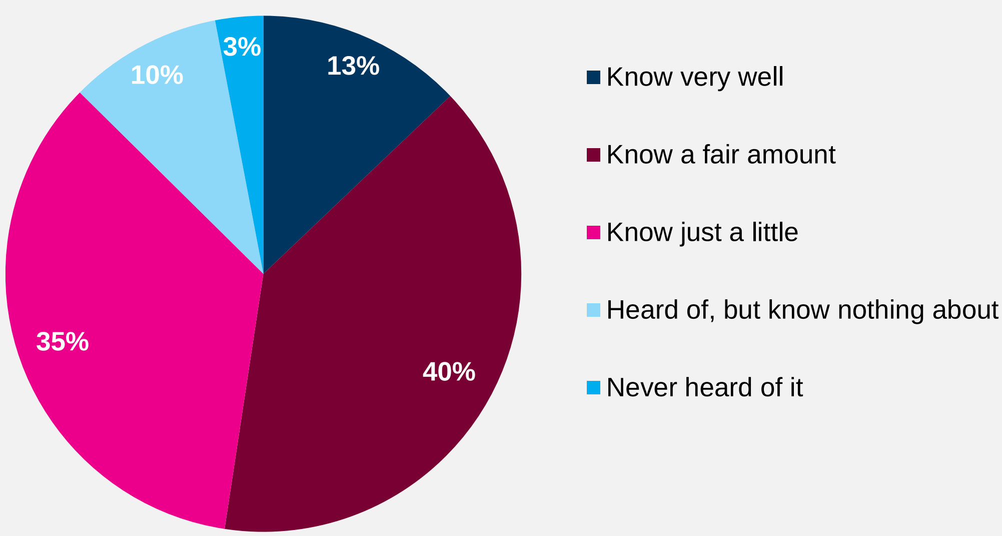
The government has announced a set of proposals that will change the way IR35 works for public sector engagements. A survey is currently being conducted among independent professionals which seeks to understand how the proposed changes might affect their business. This document provides results from a survey conducted between 14 June and 25 July 2016, and compiled from the responses of 829 IPSE members and non-members who have worked on public sector contracts in the last two years.

Knowledge of the proposal

Participants are quite well informed of the proposal to change the way IR35 works for public sector engagements.

- **Over half** (53%) 'know a fair amount' or 'know very well' about the proposal – **13% know about the proposal very well**, compared to **40% who know a fair amount**
- **Over a third** (35%) of participants '**know just a little**' about the proposals
- **10%** have '**heard of, but know nothing about**' the proposals
- Only **3%** have '**never heard of it**'

How well, or otherwise, do you feel you know about this proposal to change the way IR35 works for public sector engagements?



Total responses: 823. Percentages do not sum to 100 due to rounding

Response if the proposal is enacted

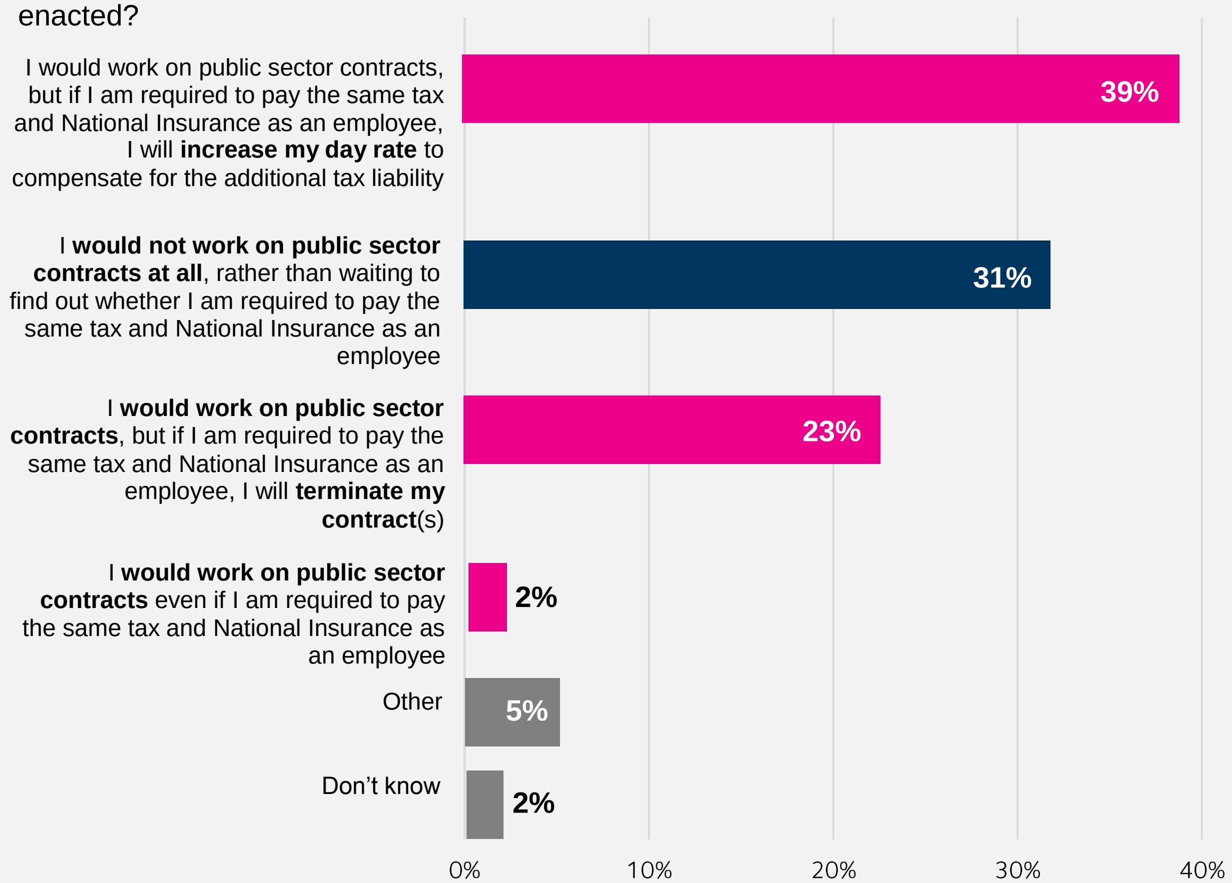
If the proposal is enacted, it is likely to have an adverse effect on independent professionals' likelihood to work on public sector contracts.

- **31%** indicated that they **would not work on public sector contracts** at all, rather than waiting to find out whether they are required to pay the same tax and National Insurance as an employee

Some respondents would remain working on public sector contracts with caution or make adjustments to accommodate the changes.

- **39%** would **increase their day rate** to compensate for the additional tax liability
- **23%** indicated that they **would continue to work on public sector contracts, but if required to pay the same tax and National Insurance as an employee, they will terminate their contract(s)**
- Only **2% would continue to work on public sector contracts** even if they're required to pay the same tax and National Insurance as an employee

Which of the following options best describes the way you would work if the proposal is enacted?



Total responses: 806. Percentages do not sum to 100 due to rounding.

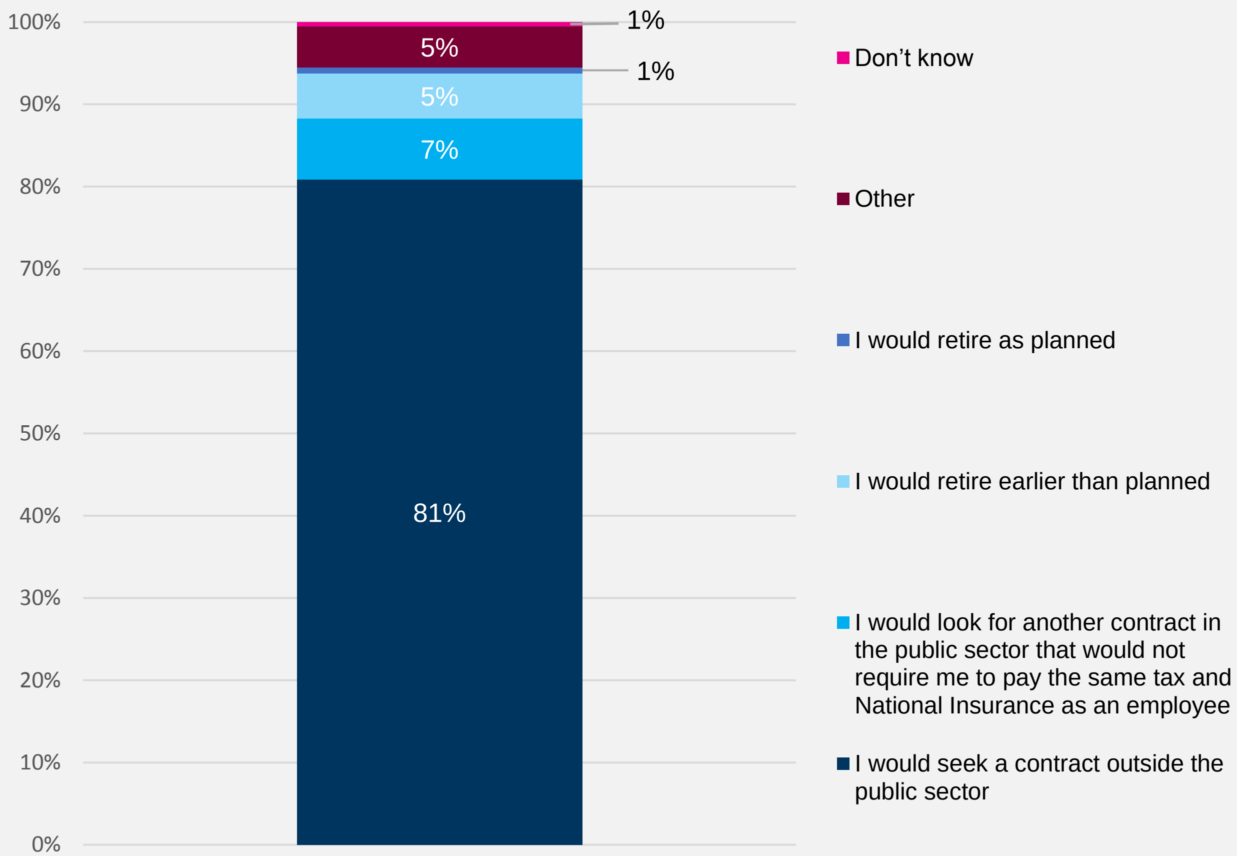
Alternative work options

Respondents who indicated that they would **terminate their contract**(s) or **not work on public sector contracts at all** if the proposal are enacted, were also asked what they would do as an alternative. Responses to this question are based on a subset of the whole sample.

The top options were:

- The **majority (81%)** said they would **seek contract work outside the public sector** instead
- **7%** would **look for another contract in the public sector** in which they are not required to pay the same tax and National Insurance as an employee
- **5%** would **retire earlier than planned,** and a further **1%** would **retire as planned**

You said you would terminate your contract(s) or not work on public sector contracts at all if the proposal is enacted. Which of the following options best describes what you would do instead?



Total responses: 423.

Treatment of taxes and employment rights

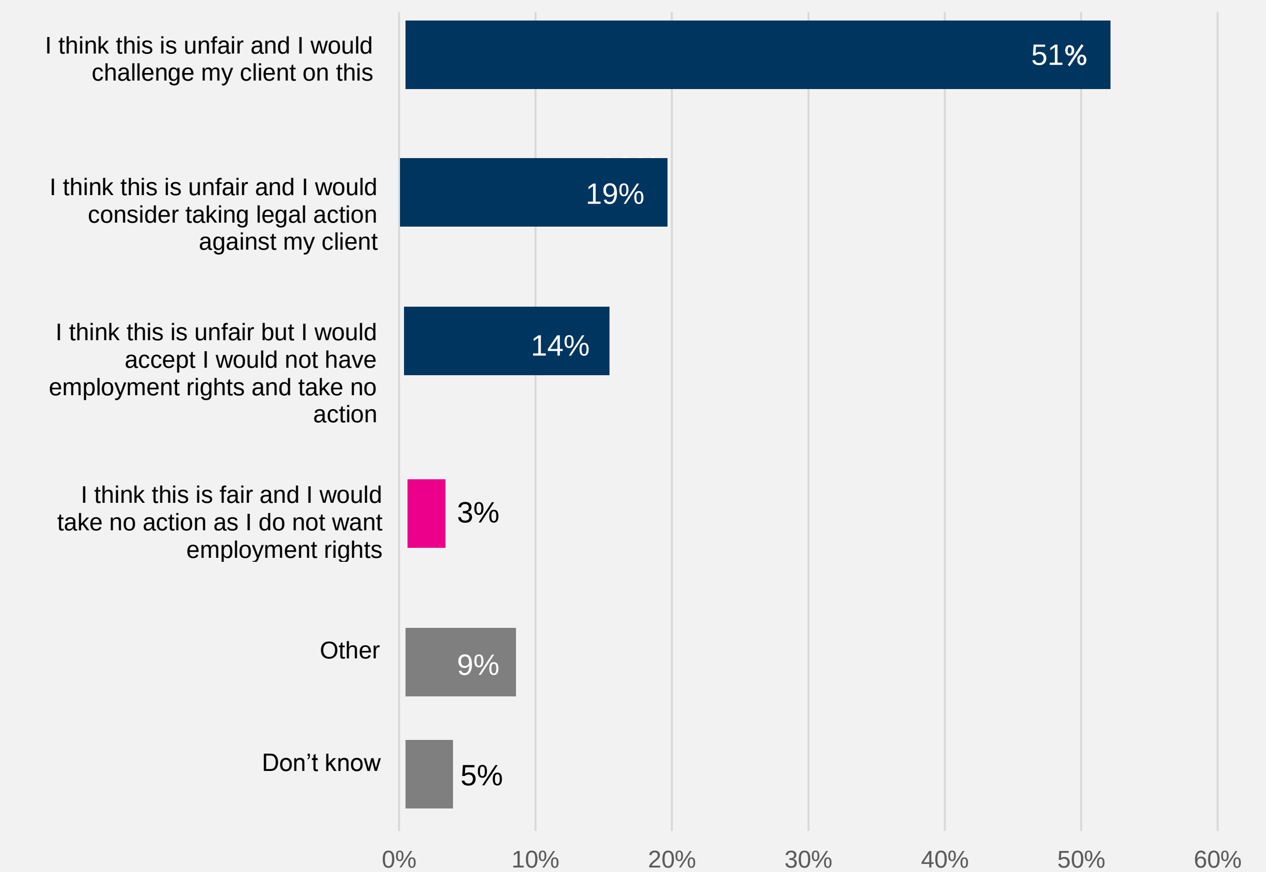
Respondents were asked how they would feel if they were to continue to work on public sector contracts and were required to pay the same tax and National Insurance as an employee, but not have the same employment rights (e.g. pension, holiday pay, statutory sick pay and statutory maternity pay).

A total of **84% think this is unfair**.

- **51%** think **this is unfair** and would **challenge their client** on this
- **19%** think **this is unfair** and would **consider taking legal action against their client**
- **14%** think **this is unfair** but **would accept that they would not have employment rights** and **take no action**

3% think **this is fair** and would **take no action** as they **do not want employment rights.**

If you were to continue to work on public sector contracts, you may be required to pay the same tax and National Insurance as an employee, but would not have the same employment rights (e.g. pension, holiday pay, statutory sick pay and statutory maternity pay). Which of the following options best describes your thoughts on this?



Total responses: 800. Percentages do not sum to 100 due to rounding.

The Freelancer Limited Company

A new tailored entity for freelancers

September 2015

For discussion

Contents

Executive Summary

This paper sets out the rationale for a new categorisation of companies for tax purposes that would provide a benign environment for freelancing to flourish, and allow HMRC to focus its attention on higher risk and more fruitful areas.

The Freelancer Limited Company ("FLC") would be a normal company formed under the Companies Act but would choose to operate under particular restrictions in order to qualify for the specific tax treatment.

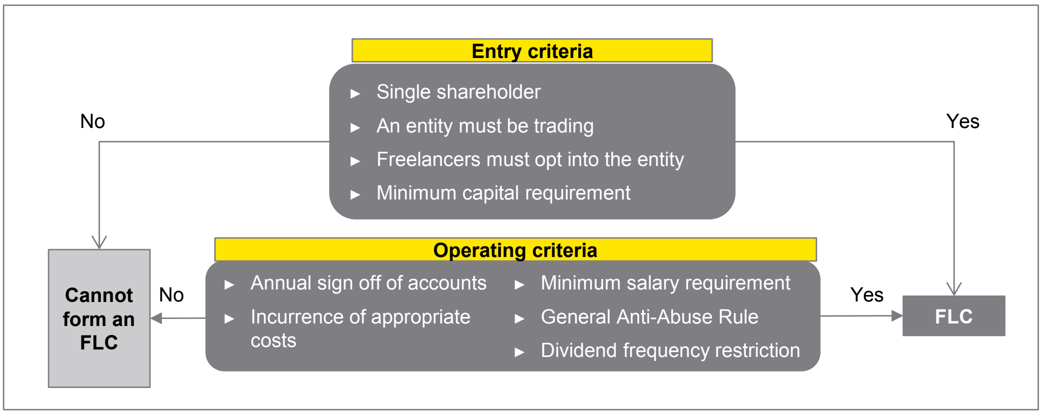
This would free freelancers from the perils of unnecessary and burdensome IR35 audits, allowing them to focus on the contribution to growth that their activities deliver. The FLC delivers this through a combination of:

- Entry tests
- Ongoing tests
- Exit implications

Those companies that meet the requirements of the FLC would:

- be considered to have met the IR35 requirements and therefore not operating as a tool for disguised employment;
- have a simplified and certain tax treatment (i.e. tax opaque and paying corporation tax on net profits with revenue recognised on a cash basis); and
- have limited liability.

There is also potential for other simplified administrative and regulatory requirements to also be attached to the FLC status.



Tax treatment

Where the freelancer has met all entry and operating criteria **for the tax year:**

- Revenue would be recognised on a cash basis, providing immediate tax relief for bad debts and in line with HMRC's approach to other small businesses.
- All costs incurred in the relation to the running of the business would be tax deductible, subject to the usual constraints (e.g. no deduction for client entertaining or bribes)
- The FLC would not be tax transparent, but would pay corporation tax on the net profits

1. Introduction

On 17 July HMRC published "*Intermediaries Legislation (IR35): discussion document*" asking stakeholders for proposals for how to improve the effectiveness of IR35 in a way that that meets the objectives set by Government. The paper suggested that:

> *"Another option could be to look again at some of the suggestions considered by the OTS" [Office for Tax Simplification]*

One of the suggestions included in the final OTS report on Employment Status[1] was:

> *"… a new 'third way', i.e. an entirely new employment status in the tax system."*

This paper sets out the design of an FLC and how such a proposal might operate to meet the aims of both Industry and Government's. The FLC is not a reform of IR35 but a vehicle for removing the burden of wasted enquires from those for whom there is limited risk and allowing HMRC to focus such resources on riskier areas.

1.1 The challenging role of the freelancer

It is estimated that 14.5%[2] of the total of workforce are self-employed. Freelancers help businesses innovate, maximise performance across peaks and troughs in demand, and create jobs by increasing the level of innovation and efficiency in the economy. However the taxation of freelancers has not been clear, indeed the taxation of people in business has developed over time, with Corporation Tax having just passed its 50th birthday, born out of the Schedules of the Income Tax system. Since then, it has been further adapted to meet the need of taxing business. In contrast, the income tax system has become increasingly focused on being the tax regime for employees.

In this increasingly differentiated system, the freelancer is forced to operate. A freelancer can be seen to have elements of both personal tax (with his/her source of income being the work undertaken in person) and business tax (since this is source of the income).

This dichotomy has been acknowledged by the Office for Tax Simplification:

> *"The tax system is stuck in an out-of-date mindset. In the 1950s and 1960s the distinction between employees and the classic self-employed jobbing plumber was clear and easy. Nowadays working patterns are hugely varied, freelancing is a way of life for many and that simple split doesn't work often enough. This causes uncertainty, risk and administrative burdens all round."*[3]

Freelancers can be differentiated from employees in that they generally have:

- No annual holiday, sickness, maternity, paternity or other benefits and therefore the need to fund these themselves
- Different workplace relations arrangements, including the ability for work to be cancelled on very short notice
- The requirement to account for their own pension arrangements
- The additional cost associated with acting as a freelancer, e.g. training, equipment, transport and travel expenses, time and cost involved in winning work etc.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/422248/OTS_Employment_Status_report.pdf

[2] http://www.ons.gov.uk/ons/dcp171778_414231.pdf (calculation based on 31.09m people in the labour market and 4.51m self-employed, p.10)

[3] John Whiting, Tax Director of the Office of Tax Simplification.

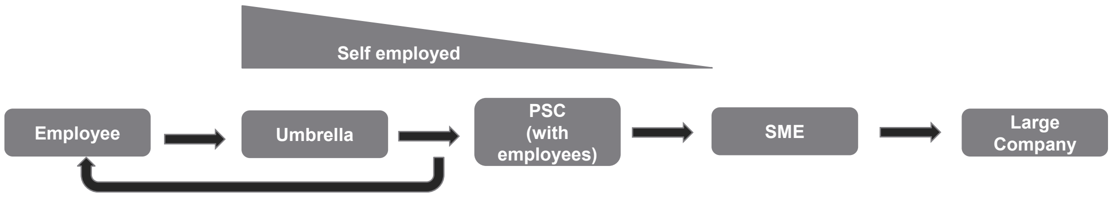
Similarly, freelancers can be differentiated from large companies in that revenue is generally based upon the individual's labour alone rather than a wider pool of profit-generating activity.

Given that freelancers do not fit neatly into either category (i.e. employee or large company) it is perhaps unsurprising that the tax system creates concerns and risks for the freelancer (see Appendix A), rather than acting merely as a mechanism for collecting the tax due in a simple and transparent manner.

1.2 Providing the right framework for the freelancer

Freelancers will come from all areas but can generally be expected to include individuals who challenge the status quo and are confident in their abilities, both key characteristics needed to prosper. With this background, it is perhaps not surprising that freelancing exists in the UK, even within a far from optimal tax environment.

The options can be seen in the diagram below. This shows a common starting point for freelancers, of learning their skills as an employee and then moving away from employment into freelancing.



None of the choices available to the freelancer is ideal, and the choice that is adopted will depend critically on the range of factors specific to that individual. Some of the attractions of the individual options are set out below:

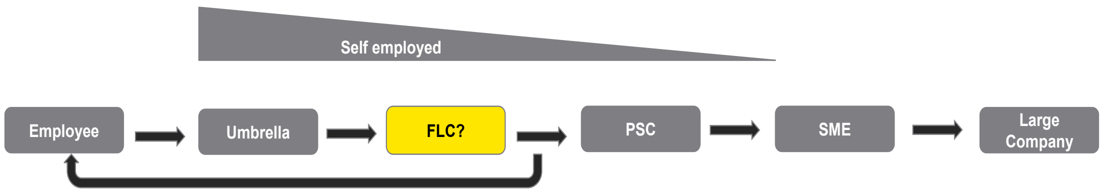
- Self-employment used to be the natural choice, but the lack of limitation of liability and the demands of the contracting market have made this suboptimal.

- Joining an umbrella provides a corporate shell, with its low administration costs, but does not reflect the entrepreneurial activities of the freelancer.

- Running their own personal service company ("PSC") provides the freelancer with all of the control needed, but also imposes a level of burden that is required of small companies, rather than tailored to the freelancer.

- Working with others to form their own small business can be a natural option, but represents a development from the freelancer model to being in business with other people and bearing additional (non-freelancer) risks. Whilst this is appropriate for some, it leaves the freelancer cohort without a viable vehicle.

Based on the above, it can be seen that there is no ideal option for freelancers. Consequently, this paper now considers the benefits of providing a tailored option for freelancers that would be adapted to their precise needs. This would allow freelancers to focus on the entrepreneurial activity that will drive growth, rather than being diverted into ensuring that they satisfy anti-avoidance rules that are designed to project the exchequer from abuse by others.



2. What is a Freelancer Limited Company?

2.1 The premise of the FLC

The benefit of developing a new tax categorisation of companies in the form of the Freelancer Limited Company (FLC) is that tests can be included within the requirements to be an FLC that mean that less onerous tests can be made of the activities undertaken within the FLC. Whilst the freelancer population can be relatively diverse, the premise of the FLC is that there is a core element for whom it should be relatively easy to identify characteristics that demonstrate that they are not disguised employees and therefore do not need to be subjected to the demands and uncertainties of the tax provisions which are aimed at disguised employment.

Freelancers working within the entity would therefore be able to apply simplified tax, administrative, and potentially even other regulatory requirements for freelancers.

The use of an entity allows the following types of test:

- The eligibility criteria for entry into (or formation of) an FLC
- The legal and regulatory requirements
- The differing tax treatment of such a new entity
- The consequences of the retirement of the FLC

This new entity would be designed to ensure that all of those within it were operating as genuine freelancers, creating a mechanism that would allow more appropriate and tailored tax treatment of freelancers. It could then be used to resolve some of the issues above. For example, it could be used to provide:

- appropriate incentives;
- a simplified and more streamlined administrative system by removing FLCs from the remit of IR35; and
- greater certainty.

The IR35 rules would only be applied to determine employment status in the event that an FLC fails any of the operating or entry tests on an annual basis.

It is not intended that an FLC would be a new type of company in the UK law. Instead this would be a UK Limited company which adopts a particular memorandum and articles of association.

2.2 The entry criteria

The first element to forming an FLC (or converting to an FLC) is to satisfy the requirements on eligibility. These can be tests inherent in the structure of the legal entity or requirements that need to be met in operating the legal entity.

Addressing the Government’s concern about avoidance and potential for disguised employment through strict eligibility criteria for the FLC will allow the application of a tailored tax treatment. The objective is for eligibility tests to be sufficiently tight to only allow the targeted group of freelancers into the FLC.

The proposed tests include:

- Single shareholder
- An entity must be trading
- Categorisation as an FLC would be optional
- Minimum capital requirement

2.2.1 Single shareholder

The FLC would be introduced with the requirement that the entity would only be eligible if it has a single shareholder (i.e. the freelancer). The entity would be able to employ any number of employees or fee earners. Freelancers would also be able to work together on particular jobs, as this could be undertaken as a partnership of FLCs (formal or informal).

2.2.2 An entity must be trading

The FLC is not intended to be a vehicle for holding investments, but for facilitating the entrepreneurial activities of freelancers. The definition of 'trading' would be the existing definition used within the tax system. This has been established in case law and considers the 'badges of trade' which include the profit-seeking motive and the way sales are achieved.

It is expected that this would be a relatively easy test to meet, given the nature of freelancing.

2.2.3 Freelancers must opt into the entity

Whilst not strictly a criteria, it is intended that the decision to become an FLC would be at the option of the freelancer. This is inherent in the diverse nature of freelancing and the fact that currently meeting the requirements of the FLC may not mean that the freelancer's plans are compatible with FLC requirements in the future. For example, a particular freelancer might see freelancing as an interim stage before expanding to take on employees.

2.2.4 Minimum capital requirement

A key requirement of the FLC is to distinguish between the disguised employee and the freelancer who is genuinely "in business on his/her own account". Previous proposals have included onerous financial requirements that impose such a significant burden as to deter disguised employment. However, such burdens would also place a high cost on freelancers and deter adoption.

Instead the FLC requirement has been designed to fit with the fundamentals of freelancing, namely that the freelancer is in business and needs to use the funds available in furtherance of that business.

It is therefore proposed that, upon creation, an FLC would have a minimum level of share capital of, say, £5,000 or £10,000. At the time of creation, the share capital could be unpaid, thereby reducing the burden imposed on the freelancer.

The freelancer would then be required to pay up the capital over time, based on a minimum per year of the higher of 5% of dividends or taxable profits (or perhaps based on a measure of turnover). This would contribute to ensuring that the FLC was maintained as a business vehicle and not used merely for avoiding disguised employment. In addition, the funds would remain available to the FLC, rather than requiring that they are held in a specific account. This would therefore enable payment as salary or in relation to expenses of the business, precluding only the payment of a dividend. Capital gains treatment would apply to any disposal of the share capital.

2.3 The operating criteria

In addition to the fundamental requirements for qualifying for an FLC, the operation of the FLC would impose a number of constrains and requirements. These are designed to ensure that the FLC remains attractive to the freelancer but not to disguised employees. The conditions could include:

- Annual sign off of accounts
- Incurrence of appropriate costs
- Minimum salary requirement
- General Anti-Abuse Rule
- Dividend frequency restriction

The impact of the test being failed also needs to be commensurate to the reasons for the failure. For example, a reversion to quasi-employment due to external factors might result in the company falling out of the special regime for the FLC and back into the normal regime, without a clawback of any benefits in the current and previous periods. Therefore the usual IR35 rules, as altered by the outcome of the proposals included in the summer budget, would then apply to the treatment of contracts.

2.3.1 Annual sign off of accounts

Inherent in the design of the FLC is the assumption that the freelancer is in business on his/her own account. Consequently, it will be important for the FLC to maintain accounts of the business activities and the imposition of a requirement to prepare accounts should not be onerous.

In addition to the preparation of the accounts, the accounts of the FLC would need to be reviewed by a reporting accountant. This requirement could be aligned with existing requirements for accounts.

2.3.2 Incurrence of appropriate costs

The inclusion of requirements for the FLC to meet requirements that would naturally fall part of the freelancer’s costs will provide an additional deterrent for those who are not freelancers but are merely seeking to use the FLC to reduce their tax bills. The costs required should be those that would be required of the whole cohort of freelancers and therefore may be limited. Example costs would include director liability insurance and public liability insurance. This could be expanded to cover other likely costs.

Other costs covered within this section would include those inherent in the freelancer way of working. This would require that, for example, the business:

- incurs any regulatory running and marketing costs;
- bears the day to day expense of doing business with clients (for example equipment, marketing, etc.) which is built into margins or mark-up, rather than obtaining direct reimbursement of these costs from client;
- receives no sick and holiday payments;
- controls the process of winning and managing work;
- wins work through submitting quotes or bids;
- issues invoices when work is done; and
- makes good unsatisfactory work at no cost.

2.3.3 Minimum salary requirement

A key driver behind the use of corporate vehicles for disguising employment is the ability to convert earned income into unearned income (e.g. dividends). One option would therefore be to impose a minimum proportion of net profits before salary costs that need to be paid as salary to the freelancer. One possibility might be a 30% requirement. This 30% requirement will necessarily impact the “tax efficiency” of the structure but it is intended that the certainty afforded by the FLC would result in the FLC remaining attractive.

2.3.4 General Anti-Abuse Rule

The UK now has a General Anti-Abuse Rule (“GAAR”) that applies to income tax, corporation tax and national insurance. Therefore it is likely that HMRC would want a GAAR to apply in the case of any FLC. The preamble of the FLC would clearly set out the reasons for the creation of the FLC as a tax policy, and therefore would naturally allow the rule to be applied in appropriate circumstances.

The protections currently inherent in the GAAR would act to constrain the potential for misuse of this provision.

2.3.5 Dividend frequency restriction

Another way to minimise the use of the FLC as a tax-motivated disguised employment vehicle, is to restrict the frequency of dividends. In some tax-motivated structures, profits are distributed on a weekly or monthly basis, as the profits take the place of salary.

In order to restrict the misuse of the FLC in a way that does not impact freelancers, there could be a limitation of dividends, for example to one per quarter, potentially with an option for an extraordinary dividend in exceptional circumstances. This would be one of the items that would be considered in evaluating the GAAR test above.

2.4 Reversion to existing tax treatment where tests are not met on an annual basis

The aim of the FLC provisions are to make sure that any business that meets the entry and operating requirements of the FLC must naturally be freelancing and therefore there is no need to apply any specific tax tests. This would avoid the current uncertainty that is plaguing the freelancing sector.

2.5 Retirement from the FLC

A final consideration in discussing the design of a proposed FLC is how to exit from the structure. For example the proposal that the FLC should be subject to the normal provisions relating to the disincorporation of a company, such that these would impose a level of difficulty in moving from one form of activity to another. The FLC is designed to apply to a set group of people seeking to do business in this way, and not to be a mechanism for merely maximising the after tax return of that work.

In addition to the constraints on returning capital from a company, the “retirement” of an FLC could also have the following consequences:

- A time limit on the freelancer re-entering a FLC structure for the same main business occupation.

- A greater tax charge on the return of capital.

Provisions could be put in place for an FLC to become dormant as the freelancers circumstances change.

3. The tax treatment of an FLC

3.1 The choice of taxation options

The tax characteristics will depend on how tightly the eligibility criteria discussed above is set. The tighter the entry into the structure, the more potential there is for beneficial tax treatment.

The purpose of the tax treatment would be to mirror the treatment that would be inherent in the tax systems as it currently stands, but with the potential to reduce the administrative burden. Furthermore, the restrictions on the operation of the FLC (e.g. single shareholder) will naturally result in higher taxation if there is not adaptation through the treatment of the revenues of the FLC.

The key principles would be:

- Revenue would be recognised on a cash basis, providing immediate tax relief for bad debts and in line with HMRC's approach to other small businesses.
- All costs incurred in the relation to the running of the business would be tax deductible, subject to the usual constraints (e.g. no deduction for client entertaining or bribes).
- Given that the FLC is established as a Limited Company but operating under particular restrictions, the FLC would not be tax transparent and would pay corporation tax on the net profits.

This tax treatment would reflect the fact that having passed the above tests the freelancer may have assets, contractual agreements, investments and limited liability.

3.2 Setting the tax rate

The July 2015 Budget has highlighted the Government's renewed appetite for addressing tax motivated incorporation and has increased the effective tax rate of the PSC structure. The tax rate of the FLC could be set at a rate broadly equivalent to the rate obtained in a PSC.

4. Conclusion

The benefits of the FLC structure include:

- It reduces administration for both the freelancer and HMRC
- It would allow attention to be focused on high risk areas.
- Frees up freelancers to focus on business opportunities
- Works within the existing legal system
- Simple to introduce and does not complicate the existing system for others

The FLC could introduce the following risks which can be mitigated as follows:

Risk	Mitigation
Loss of revenue to the Exchequer	**Strength of the entry and operational tests**
Additional complexity to the tax system	**Only applies to those who opt in and is simple to operate**

A. Issues with the current tax system

The failure of the current tax system to easily adapt to the changes in the way that people work and business is conducted has a number of impacts on freelancers who seek to operate.

- The cost of complying with the system

  Freelancers have to exert a great deal of effort and administration to ensure that they are compliant with the tax law. This level of resource is disproportionally large for a single freelancer compared to a Small and Medium Enterprise (SME) or larger company.

- Uncertainty and competitiveness

  The current tax policy environment for freelancers is defined by HMRC concerns surrounding the operation of umbrella companies and the prevention of tax avoidance through disguised employment. This may be exacerbated by market participants who do not fully understand or know about the application of IR35, and how these constraints and regulations may apply to their operations. Even after various compliance requirements are met, there is still a reasonably high level of uncertainty about whether a genuine freelancer is on the correct side of the tax law or not.

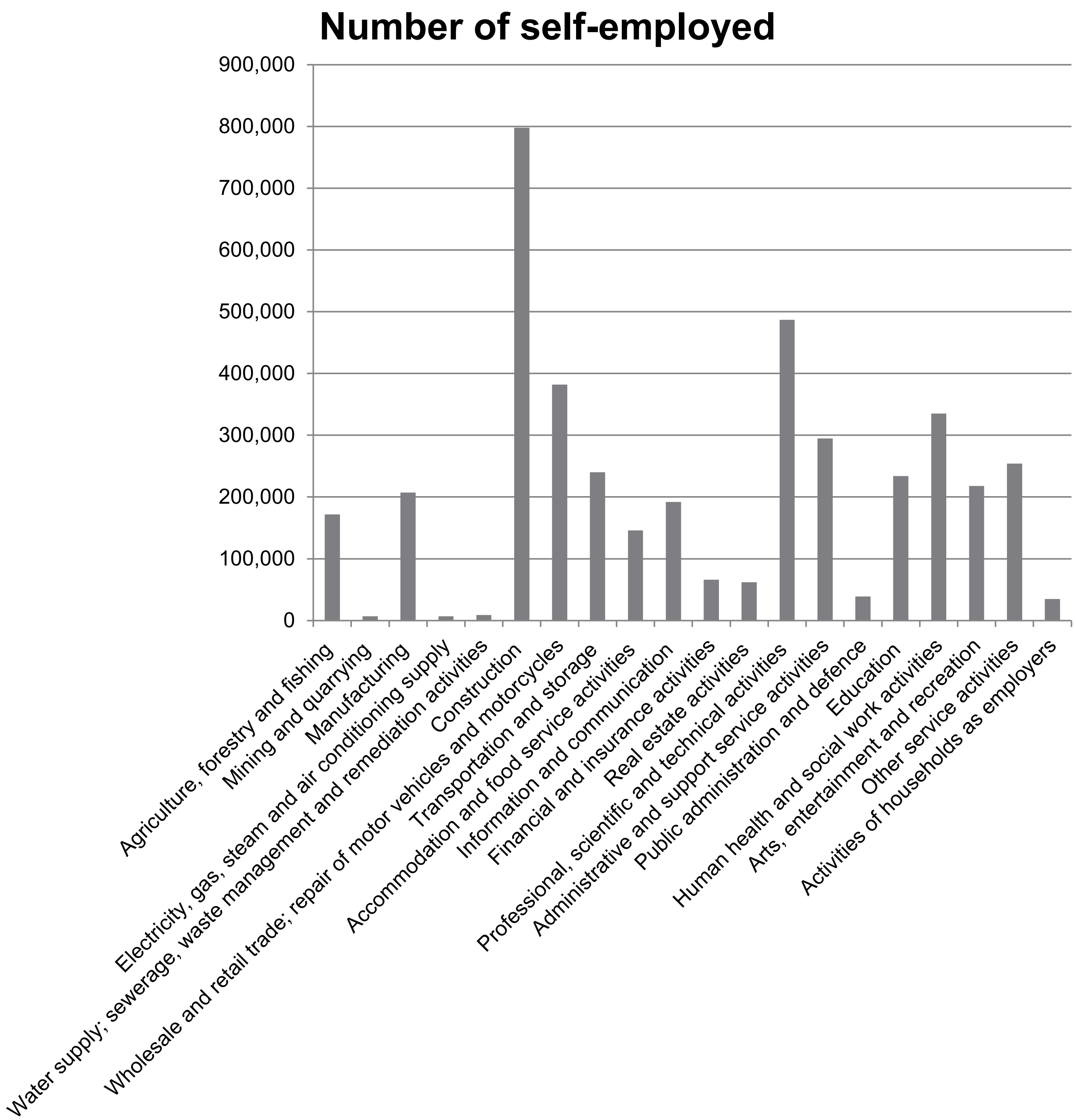
- The implications of an investigation

  In the event that an investigation is undertaken against an individual there are potentially high costs of one's defence. An investigation can take anywhere from 18 months to 2 years to resolve and can reach back historically 6 years. If an investigation is undertaken, the risks and costs to the individual and their business can include reputational damage along with loss of revenue and income. The threat of an investigation alone could result in reputational damage and business loss to the freelancer.

- Unfair playing field compared to other business

  This uncertainty within the system has competitive consequences for freelancers in competing within the market for business to business transactions is not level. The uncertainty related to potential tax and compliance issues in employing a single freelancer compared to engaging a consultant employed through a large business means that there is not a fair playing field between freelancers and businesses.

B. Number of self-employed people by occupation



Based on Office of Tax Simplification, Employment status report: March 2015.