

The Freelancer Limited Company

A new tailored entity for freelancers

September 2015

For discussion

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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.

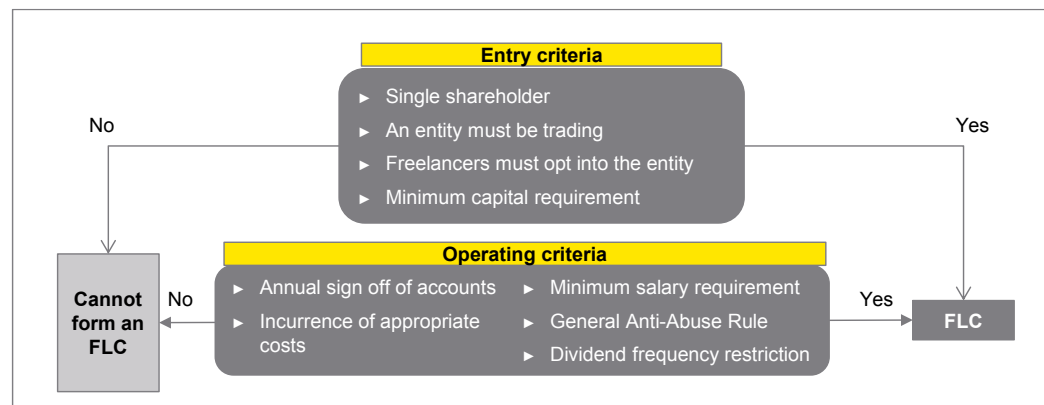
This would free freelancers from the perils of unnecessary and burdensome IR35 audits, allowing them to focus on the contribution to growth that their activities deliver. The FLC delivers this through a combination of:

- 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 Status¹ 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.

¹https://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.

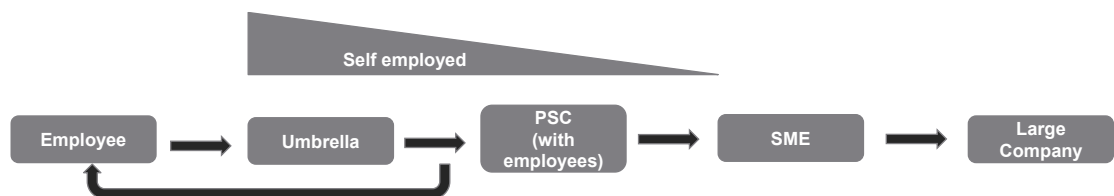
Similarly, freelancers can be differentiated from large companies in that revenue is generally based upon the individual's labour alone rather than a wider pool of profit-generating activity.

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.

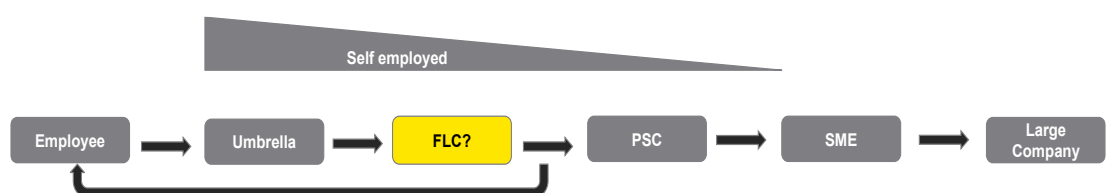
The options can be seen in the diagram below. This shows a common starting point for freelancers, of learning their skills as an employee and then moving away from employment into freelancing.



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 constraints 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 disproportionately 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.

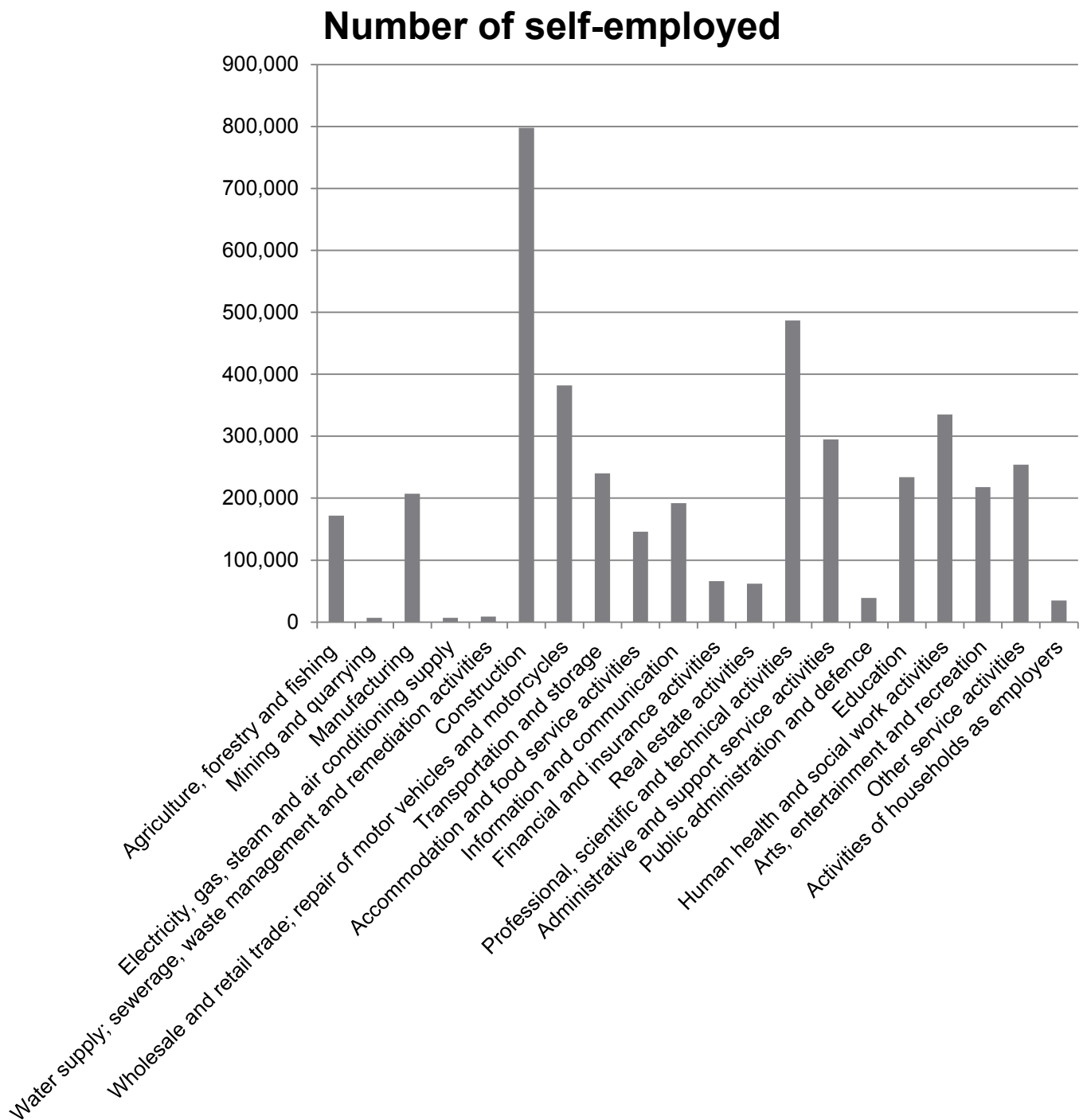
- The implications of an investigation

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.