



Off-payroll working in the private sector
IPSE response to the HMRC consultation document

August 2018

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1. Summary of IPSE's position

IPSE believes the application of the lead proposal – extending the 2017 public sector reforms - will be damaging, not just to the Personal Service Companies and the agencies in the supply chain, but to their private sector clients and the economy as a whole.

The proposal will:

- Heap significant cost onto businesses
- Restrict the private sector's access to the specialist skills it needs
- 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
- Swamp UK businesses in red tape
- Damage UK productivity
- Result in multi-national businesses shifting projects off-shore
- Encourage further use of non-compliant umbrella arrangements and tax evasion schemes

The other two options put forward will be less damaging, though may well still have a negative impact when considered in the round. Each of those options will be considered in this response, however, it is clear that extending the public sector reforms is the government's preferred option, so the bulk of this submission will focus on that. Throughout this response the public sector reform extension proposal is referred to as 'the lead proposal'.

1.1 Brexit

IPSE believes the lead 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 pound is extremely low against benchmark currencies.

Now more than ever the government needs to prioritise the issues that 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.

IPSE's Freelancer Confidence Index¹ – a quarterly survey of freelancers that tracks the business performance and economic outlook of independent professionals and the self-employed in the UK – has consistently shown that Brexit is a major concern. Companies already starting to hold back in investing in skilled resources and this proposal will only exacerbate that.

1.2 UK Productivity

The lead proposal would cause a significant increase in required resourcing for businesses, as well as for HMRC. Time spent on the almost impossible task of determining the IR35 status of off-payroll engagements, is time not spent on productive business activity. For engagements that have been deemed inside IR35, businesses will also need to consider how they can process payments to personal service companies via the payroll, while still reconciling VAT payments – an issue which remains unresolved since the public sector reforms were implemented last year.

With continuing uncertainty and a growing burden on business, the lead proposal risks damaging the UK's productivity.

¹ [Freelancer Confidence Index](#), IPSE, Q1 2018

1.3 Recommendations

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

Recommendation 1 – The lead 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. We also make further recommendations, for the government's consideration:

Recommendation 2 - Adopt the Freelancer Limited Company (notwithstanding that it has been explicitly 'scoped-out' in the consultation document).

Recommendation 3 – To ensure certainty and stability for business, government should delay any changes to IR35 until it has brought forward measures on the back of the recent Employment Status consultation. IR35 compliance could be made much simpler, or even redundant, if clear, unambiguous rules around status are introduced in the first instance.

Recommendation 4 – Government should undertake a strategic review of the taxation of income, including National Insurance Contributions (NICs)

Should the Government persist with the lead proposal, we would make the following, further recommendations:

- i) **Delay implementation of the proposal until there is consensus that the Check Employment Status for Tax (CEST) tool works**
- ii) **Explicitly rule out implementation in April 2019**
- iii) **Consider an exemption for SMEs and micro businesses**
- iv) **Liability should remain with the client, not the agency, and individuals deemed to be operating inside IR35 should be placed on the client's payroll, not that of the agency or other third party (typically an umbrella)**
- v) **Commission an independent body to conduct a full review of the public sector reform, after January 2019 deadline for the 2017 – 18 self-assessment**
- vi) **Introduce a straight forward appeals process to allow individuals to challenge incorrect determinations**

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 74,000 members and associates

2.1 Independent Professionals

Often referred to as freelancers, contractors and consultants, 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. In its report for the Autumn Statement 2016, the Office of Budget Responsibility (OBR) noted that the rise in incorporations was not necessarily tax motivated:

"Not all these incorporations are tax-motivated, as incorporation provides other benefits such as limited liability status. Operating as a company is an increasingly common way to structure a business in a

number of sectors – particularly construction, retail, IT, media and professional services. These sectors account for more than half the modelled company population in 2014.”²

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, IPSE, in this response, 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 that the Government is referring to what we might describe as ‘limited company contractor businesses’.

3. About this response

3.1 This response has been based on:

- Independent research by ComRes – full report available in the Appendix
- A survey of 1,290 public sector contractors and 115 public sector hiring managers, carried out jointly with IPSE and the Chartered Institute of Personnel and Development (CIPD) – full survey results are available in the Appendix
- Roundtable events and focus groups with members, HMRC and other stakeholders and experts
- Face to face consultation with IPSE’s membership
- Discussion on IPSE’s online forum

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

Although it has been deemed ‘out-of-scope’, we believe further consideration of the ‘Freelancer Limited Company’ (FLC), which we developed in 2015 with EY, could bring about greater compliance, and raise more revenue than the lead proposal. It would also place far less burden on business.

The FLC would provide clarity of status of freelancers that chose it and protect revenue. In its report on Small company Taxation, the Office of Tax Simplification endorsed the FLC as worthy of further consideration³. Some two years ago, IPSE had preliminary discussions with HMRC and HMT officials on the FLC and we still 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 the Appendix.

5. IR35 is ineffective and should be abolished

² [Economic and Fiscal Outlook](#), The Office of Budget Responsibility, November 2016, page 122

³ [Small Company Taxation report](#), The Office of Tax Simplification, March 2016, page 10

5.1 IR35 is inherently flawed

The rules which determine status are so unclear it is impossible to know with any certainty whether an individual engagement falls within IR35's scope. The CEST tool, which is supposed to enable accurate determinations has been heavily criticised by many independent experts. (CEST is discussed in more detail later in this response.)

Even HMRC, with all its undoubted expertise in IR35, has been unable to accurately assess IR35 status, having lost three out of the four cases which have come to light this year.

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

5.2 Recommendation 3 – To ensure certainty and stability for business, government should delay any changes to IR35 until it has brought forward measures on the back of the recent Employment Status consultation. IR35 compliance could be made much simpler, or even redundant, if clear, unambiguous rules around status are introduced in the first instance.

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; around 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. IPSE welcomed Matthew Taylor's review of Modern Working Practices and the subsequent consultation on Employment Status. We hope these consultations will result in clearer rules around employment and tax status. Once those rules have been established, it is likely IR35 status will also become clearer and it may at that stage be appropriate to ask clients to assess engagements. However, until the rules have been clarified it is unreasonable to ask businesses to make status determinations as it is so difficult to be certain that those determinations are correct.

Indeed, if employment and tax status is sufficiently clarified, it may be possible to do away with IR35 entirely as it will be clear to all parties in any engagement whether the individual concerned is employed or self-employed and how their income should be treated for tax purposes.

6. Employment status v tax status

This proposal seeks to identify certain individuals as 'employed for tax purposes' and deduct PAYE and NI without providing the benefits and protections that come with employment.

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.

6.1 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

Under the proposal, the engaging company 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 CEST 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 – they 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 9.4) it will unnecessarily rob itself of the flexibility, efficiency and specialist skills that PSCs provide (see section 8 on the economic contribution of PSCs).

One of the central tenants of the government's work around the Taylor Review and the Employment Status consultation is ensuring individuals are provided with the appropriate employment rights for the roles they undertake. This proposal flies in the face of that laudable aim.

A more consistent approach would be to clarify the position on employment status, then consider tax reforms that complement those changes.

6.2 Recommendation 4 – Government should undertake a strategic review of the taxation of income, including NICs

The tax system needs to be radically overhauled in order to keep pace with rapidly changing modes of working. 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 Simplification⁴. This review should be undertaken after any changes on the back of the Employment Status consultation have been implemented.

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

The executive summary to the consultation document states, 'There is evidence that ... non-compliance *(with the intermediaries legislation)* is widespread'.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' rules⁶. 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'.

In an answer to a recent Parliamentary Question, the Parliamentary Under-Secretary at the Department for Work and Pensions said that a relatively small of contractors at the Department were found to be operating inside the IR35 rules:

"We understand this question to refers to the IR35 status of our contractors. As at 31st January 2018, the Department had 455 contractors. Of these, we have classified 22 as In-Scope of IR35 and 433 Out of scope of IR35.

⁴ See, for example, the OTS reports on [Small Company Taxation](#), March 2016 and [Employment Status](#), March 2015

⁵ [Off-payroll working in the private sector](#), HMRC, p.4 Published May 2018

⁶ [Second evaluation of tax arrangements for off-payroll contracts in the public sector](#), HM Treasury, March 2015

The Department engages and deploys its contractors to meet a wide range of requirements to support our activities. Each engagement is unique to the particular requirements of our business, in order that the deliverables required can be met. Dependent on the requirement, the Department may specify the working hours of its contractors. This will be detailed in advance, so that the contractor understands the engagement before accepting it, and will match the specific business needs of the Department's requirements. This is one of the many factors that can influence the IR35 status of an engagement which we specify up front, along with control and direction, financial risk and whether a personal service is required."⁷

IPSE believes the total number of UK engagements to which IR35 applies will be proportionate to the DWP figures i.e. 5%

However, if there is evidence of greater 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.

7.1 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 £1.2bn by 2022/23. IPSE would be interested to understand more about how government has arrived at these figures.

It is impossible to know with any certainty whether even one engagement is caught by IR35, as demonstrated by HMRC recent tribunal record. It seems impossible therefore to determine how many inside IR35 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.

7.2 PSCs make a positive contribution

IPSE acknowledges the consultation document also notes the positive contribution of PSCs:

"The government recognises that the UK's flexible labour market supports job creation and allows more people to participate in work. The option to work through an intermediary, including a PSC, helps support this labour market flexibility."⁸

8. The economic contribution of PSCs

8.1 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.

The report, which is available in the Appendix, is based upon HMRC's estimate that there were around 265,000 active PSCs in the UK in 2012/13. The report estimates this had 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 that 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:

DIRECT – 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.

⁷ [Department for Work and Pensions, Staff: Written Question 128813](#), 21 February 2018

⁸ [Off-payroll working in the private sector](#), HMRC, p.5 Published May 2018

INDIRECT – Their indirect contribution is the purchases 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.

INDUCED – 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 that PSCs contribute to the economy there is also their contribution in terms of added employment, productivity and flexibility in the UK economy.

EMPLOYMENT - 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 that these businesses supported 602,000 jobs in the UK in 2015. This includes the 307,000 people who operate 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 necessary role. Oxford Economics estimates that 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.

The government will put this economic contribution at risk if it implements the lead proposal.

9. Secondary recommendations

For the reasons outlined above, IPSE urges the Government to abandon the lead proposal. However, if it is minded to push ahead, it should consider the following points:

9.1 Delay implementation of the proposal until there is consensus that the Check Employment Status for Tax (CEST) tool works

The CEST tool was created at the same time as the reforms to IR35 were implemented in the public sector. It has been heavily criticised ever since. IPSE does not believe it will ever be possible to create a tool which can stand up to the scrutiny of case law. CEST adopts a tick-box mentality but the courts have said that you can't take that approach when looking at employment status. It is only a matter of time before we get tribunals making decisions that do not agree with CEST, which will leave businesses with no clear way to make status determinations that could be relied upon at a tribunal.

CEST does not consider mutuality of obligation. HMRC has defended this by defining mutuality of obligation as something which always exists in any contract (this is a crude summary of HMRC's position, but it is essentially accurate).

In a case from last year, which has only recently come to light (*Armitage v HMRC*) the presiding officers at the tribunal said the following of HMRC's argument:

"HMRC's case is that where one party agrees to work for the other in return for payment then this satisfies mutuality of obligation between the two parties. That would be true of every contract both employment

and for services otherwise the contract would not exist at all. The mere offer and acceptance of a piece of work does not amount to mutuality of obligation in the context of employment status.”⁹

This case was settled shortly before HMRC launched the CEST tool. So HMRC either knew, or should have known, that their argument about mutuality of obligation was on shaky ground when they launched the tool.

These arguments have been raised with HMRC at the IR35 Forum, though unfortunately there has been no change to their position, and CEST still does not consider mutuality of obligation. IPSE’s letter to the IR35 Forum, setting out our view on mutuality of obligation, is available in the Appendix (at the very back of this document).

This whole policy – shifting the responsibility for determining IR35 status onto clients - is predicated upon CEST being a reliable resource. There is no doubt that making IR35 determinations is difficult. That’s why the government created the CEST tool in the first place – to make the process of determining status simpler for clients. But there must be public confidence in CEST, which there cannot be as long as it produces results visibly at variance with what case law would suggest. The HMRC understanding of mutuality of obligation is flawed, and the case that it most recently lost has been lost on this issue.

If the government is intent on pursuing this policy, it must make changes to CEST that would bring it in line with case law.

9.2 Explicitly rule out implementation in April 2019

There are several technical problems which still have not been resolved from the public sector role out. These are:

1. There is no obvious way for an individual to appeal a determination if they think it is wrong. HMRC has said at the IR35 Forum that anyone can appeal to a ‘status officer’. If this is correct, and if there are an appropriate number of status officers with enough capacity, HMRC should make this clear in publicly available guidance.
2. There is no payroll software available which enables individuals to be placed onto the payroll. The current software does not allow for the conciliation of student loan deductions and cannot reconcile VAT payments. Big companies must be able to distinguish between ‘deemed employees for tax purposes’ and actual employees.
3. How do the PSCs file their accounts, when tax on some of their profits has already been deducted? HMRC has suggested they reduce their reported turnover yet this contravenes Section 474 of the 2006 Companies Act. The Financial Reporting Council is looking at this issue – it may require a change in legislation.
4. The Government cannot be sure of how much revenue has been raised by the public-sector change until it takes into account any rebates, and the loss of Corporation Tax. This will not be made clear until after January 2019.
5. The default Basic Rate tax code which is applied to all taxpayers that are placed onto a payroll is very often inappropriate and will cause complexity later in the tax year.
6. The Radio Industry Guidelines which govern who can and cannot be considered self-employed in the broadcasting industry are still in force. These vary significantly from the CEST tool. The Government must make clear which guidelines should be applied.
7. There is growing concern that the public-sector rule change has given rise to non-compliant umbrella models which make use of off-shore tax avoidance vehicles.

It would be reckless of the government to proceed with this measure before all of the issues above have been addressed. Given that it is unlikely to resolve the issues before April 2019, it would be reassuring to business if government would explicitly rule out 2019 implementation, as soon as possible.

⁹ [Armitage Technical Design Services v HMRC, First Tier Tribunal Tax Chamber](#), p.12

Providing this certainty for businesses ahead of the Autumn Budget would re-build trust between business and Government on this issue and allow for a more constructive discussion to get the policy right.

IPSE commissioned ComRes to conduct a qualitative survey of businesses' views about the lead proposal. Overwhelming businesses were not aware of the proposed changes. Businesses are very clearly not ready to implement the reforms in April 2019. The full survey report is available in the Appendix.¹⁰

9.3 Consider an exemption for SMEs and micro businesses

The lead proposal will cause two main issues for businesses:

- They will have to make accurate IR35 assessments, which is very difficult (perhaps impossible) as explained above, and which will create an additional administrative burden
- They will have to place individuals who are not their employees onto their payroll, causing technical accounting difficulties as explained above

These problems will be felt by all businesses, large and small, that engage PSCs. However, larger businesses may have the resources to help them to cope with these difficulties, while smaller businesses will almost certainly not.

Although IPSE believes, first and foremost, that the lead proposal should be abandoned entirely, the government may want to consider exempting businesses that meet the SME definition, as a way to ensure that smaller businesses will not be disproportionately affected.

9.4 Liability should remain with the client, not the agency, and individuals deemed to be operating inside IR35 should be placed on the client's payroll, not that of the agency or other third party (typically an umbrella)

The way the IR35 rules work in the public sector is overly complex. There are many reasons for this, not least of which is because IR35 is itself bewildering complex. A further complexity is added by where the liability rests in the supply chain.

If we have understood the rules properly, they should work as follows:

- The client is required to make an IR35 determination
- The client informs the agency (which pays the PSC) of its determination
- The agency decides whether to accept or reject the client's determination and either applies, or does not apply, IR35 as it sees fit
- If the agency chooses not to apply IR35, even after the client has determined it should apply, liability shifts to the agency

Under this system, there is no direct negative consequence to the client of an 'inside IR35' determination. The client simply states that IR35 should apply, passes that information down the chain, and then takes no further action. It is quite possible that an agency will fail to apply IR35. This could quite possibly mean non-compliance is taking place, and the exchequer is losing out on revenue, but this is of no consequence to the client – they are free of liability.

The client is also free from having to deal with the complexities of placing the individual on their payroll (listed above) – that is the agency's problem. And this is where the government commissioned IFF research lacks credibility. The research was limited to the impact on clients. It didn't analyse the impact further down the chain. If it had, it would have found an increase in the use of umbrella companies – the fact that it didn't was extremely surprising to many observers, including IPSE.

10

IPSE is very concerned that public sector clients are taking a risk averse approach, as is demonstrated by our joint survey results with CIPD, available in full in the Appendix. This would suggest that some of the additional £410m raised in tax and NI since April 2017 is money which HMRC is not entitled to. Clearly this is not an ideal scenario. We can see no reason why the private sector wouldn't also take a risk averse approach, which would mean even more tax and NI being incorrectly deducted from contractors.

As a way to ameliorate this problem, IPSE believes it would be better if the liability rested with the end client, and that where IR35 is deemed to apply, the client should place the contractor onto its payroll, and some other payroll further down the supply chain. Although IPSE is firmly of the view that IR35 status liability should rest with the PSC, it would be better that it rested with the client than with another entity down the chain. Making this change would result in the following improvements:

- Clients would make more accurate determinations
- There would be more transparency in the decision-making process – contractors would be dealing directly with their client, rather than finding out about a determination from a third party
- There would be less scope for non-compliance – where agencies fail to apply IR35
- There would be less use of umbrella companies, some of which are rumoured to be non-compliant, and even making use of off-shore evasion schemes (N.B. IPSE recognises that most umbrella companies are fully compliant)

This approach would be consistent with one of our central recommendations set out in 6.1:

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

A note on Employers' NI

Where an engagement falls within the IR35 rules the individual is deemed to be 'employed for tax purposes'. It therefore logically follows that the client is now an employer for tax purposes. The Employers' NI (Class 1a) liability should therefore rest with the client.

We have seen examples in the public sector of deductions being made, typically by an umbrella company, from the payments to contractors to account for employers' NI. There have also been deductions made to account for the Apprenticeship Levy. There is some dispute over whether this might constitute illegal deductions from wages.

As stated above, IPSE believes it would be better if the contractor were placed onto the payroll of the end client, rather than an agency or other intermediary. Were this to happen it would also result in clients carrying the employer NI burden, which would seem to be the appropriate outcome, and may help to avoid legal confusion over who should be liable.

To clarify, IPSE believes that this whole proposal should be abandoned, but if the government is minded to press ahead, it should work like this:

- Client determines IR35 status
- If IR35 is deemed to apply, client should place individual on its payroll – not a third party's
- Client should consider whether it should in fact employ the individual (it will probably find that it should)
- If the client decides it is not required to employ the individual, it should be compelled to provide a written justification
- The client should pay tax as if it were the employer
- The contractor should pay tax as if they were an employee

Currently the rules in the public sector leave too much scope for deviation from this model, which leads to complexity and excessive deductions from the individual tax payer.

9.5 Commission an independent body to conduct a full review of the public sector reform, after January 2019 deadline for the 2017 – 2018 self-assessment

As mentioned above, the IFF research was too limited in scope. The government should commission a independent body to comprehensively review the impact the recent reforms have had on the public sector, prior to private sector implementation. It should examine the impact all the way through the supply chain. The review should also consider whether accurate determinations have been made.

The review should be undertaken over at least a full tax cycle since implementation. This should allow issues that occur throughout the tax cycle to be identified, with solutions to overcome them put in place prior to potential implementation in the private sector.

9.6 Introduce a straight forward appeals process to allow individuals to challenge incorrect determinations

One of the main frustrations for contractors with the way the rules work in the public sector is that there is no appeals process. Given employment status is so complex, we feel it would be helpful if there were some avenue for contractors to challenge or appeal any conclusion of employment status made by the client.

Due to some public sector clients' excessively cautious assessment under the off-payroll rules and reliance on the CEST tool (which does not take MOO into account), many contractors are finding that their fees are being treated as employment income when they remain legitimately self-employed.

Such appeal or challenge could be either to the client itself or to some external body such as a tribunal, or even the Small Business Commissioner, although the forum for any such challenge or appeal would need to be considered further.

10. 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. For ease of reference, some of the points made above are repeated below.

1) What could be done to improve the compliance enquiry process to reduce non-compliance, whilst safeguarding the rights of customers?

As stated above, IR35 is inherently flawed. IR35 compliance is difficult, verging on impossible because nobody can say with any certainty whether IR35 should apply to a particular engagement or not.

Instead of tinkering around with who should be made liable, government should scrap IR35 and replace it with simpler measures, for example the Freelancer Limited Company.

Extending the public sector rules to the private sector

2) Could the public sector regime better fit the needs of businesses? How?

The public sector rules have caused significant difficulty for businesses, agencies and contractors. These difficulties are detailed above. IPSE strongly urges the government to abandon the proposal to extend the rules into the private sector, however, if it is intent on pressing ahead, the following changes would ease the burden:

- i) Delay implementation of the proposal until there is consensus that the Check Employment Status for Tax (CEST) tool works

- ii) Explicitly rule out implementation in April 2019
- iii) Consider an exemption for SMEs and micro-businesses
- iv) Liability should remain with the client, not the agency, and individuals deemed to be operating inside IR35 should be placed on the client's payroll, not that of the agency or other third party (typically an umbrella)
- v) Commission an independent body to conduct a full review of the public sector reform, after January 2019 deadline for the 2017 – 18 self-assessment
- vi) Introduce a straight forward appeals process to allow individuals to challenge incorrect determinations

Each of the above recommendations are explained fully in the previous section of this response.

3) What, if any, changes could help make the administration as simple as possible?

To make the administration of the rules easier for businesses, each of the following issues would need to be addressed:

1. There is no obvious way for an individual to appeal a determination if they think it is wrong. HMRC has said at the IR35 Forum that anyone can appeal to a 'status officer'. If this is correct, and if there are an appropriate number of status officers with enough capacity, HMRC should make this clear in publicly available guidance.
2. There is no payroll software available which enables individuals to be placed onto the payroll. The current software does not allow for the conciliation of student loan deductions and cannot reconcile VAT payments. Big companies must be able to distinguish between 'deemed employees for tax purposes' and actual employees.
3. How do the PSCs file their accounts, when tax on some of their profits has already been deducted? HMRC has suggested they reduce their reported turnover yet this contravenes Section 474 of the 2006 Companies Act. The Financial Reporting Council is looking at this issue – it may require a change in legislation.
4. The Government cannot be sure of how much revenue has been raised by the public-sector change until it takes into account any rebates, and the loss of Corporation Tax. This will not be made clear until after January 2019.
5. The default Basic Rate tax code which is applied to all taxpayers that are placed onto a payroll is very often inappropriate and will cause complexity later in the tax year.
6. The Radio Industry Guidelines which govern who can and cannot be considered self-employed in the broadcasting industry are still in force. These vary significantly from the CEST tool. The Government must make it clear which guidelines should be applied.
7. There is growing concern that the public-sector rule change has given rise to non-compliant umbrella models which make use of off-shore tax avoidance vehicles.

4) If the private sector rules were changed, do you have any evidence that there are parts of the private sector where the administration of any regime may need to vary even though the basic principles including for determining status, remain the same?

HMRC has adopted the view that mutuality of obligation is always present in any public hiring. It is not clear whether HMRC believes this to be true of all private sector hirings as well. If it does not, this suggests there will need to be a version of the CEST tool for the private sector.

To be clear, IPSE's position is that there is no meaningful difference between the public and the private sector with reference to IR35 status.

5) Is there any evidence that parts of the private sector will not have, or be able to acquire the administrative capacity, knowledge and resources to enable them to implement any changes in relation to off-payroll workers?

Yes. IPSE commissioned ComRes to conduct a survey of businesses – available in the appendix. It clearly shows that businesses are not aware and not ready to implement changes in relation to off-payroll workers.

6) How could these difficulties be mitigated?

The government should abandon the lead proposal. If it doesn't want to do that, it should follow the steps set out in the answer to question 2.

7) What aspects of policy design might be adjusted if similar changes were brought in for the private sector? Should we bring in a specific penalty if agencies fail to comply?

See secondary recommendations iv): Liability should remain with the client, not the agency, and individuals deemed to be operating inside IR35 should be placed on the client's payroll, not that of the agency or other third party (typically an umbrella)

8) What action should be taken in the case where the fee-payer hasn't acted upon the client's conclusion that the worker would have been regarded as an employee for income tax and NICs purposes if engaged directly? Should an obligation be placed upon the fee-payer to adopt the client's conclusion and there be sanctions for failing to do so?

See above answer to question 7.

9) What action should be taken if the worker or PSC is knowingly receiving income that has not had the right amount of tax and NICs deducted?

This question is confusing. The point of this proposal is to shift liability away from the PSC. IPSE disagrees with the proposal, but it doesn't make much sense to make that shift, then try to hold PSCs accountable when things go wrong.

10) What systems and process changes would businesses need to make?

See answer to question 3.

11) Would there be any process and administrative cost implications for businesses? Can you provide evidence of the scale and nature of these?

There would be considerable costs. See ComRes survey in the Appendix.

12) Can you provide any evidence that these costs would vary depending on how much notice businesses were provided for the introduction of any reform?

Government must ensure that all private sector engagers of off-payroll workers are made aware of their future obligations prior to implementation. Education of the private sector takes time and it is vital for any changes to be deemed a success. Time for businesses and HMRC is needed to ensure education and necessary resource allocation is achieved.

If the rules were changes in April 2019, businesses would have to develop an interim solution in order to ensure compliance. 73% of businesses' report early implementation of reforms as draining more businesses resources when compared to suitable time for implementation¹¹.

¹¹ CBI 'Off-payroll working in the private sector (IR35) legislation' survey (July 2018)

13) Is there anything else HMRC could do to ease the implementation for businesses, and can you provide evidence of how this would ease implementation or administration for businesses?

Government must address the issues raised in the answer to question 3 and follow the recommendations set out in question 2.

Encouraging or requiring businesses to secure their labour supply chains

14) Overall, what are your views on this option? Would it be a proportionate response to the issue?

It is imperative that the alternative options considered within this consultation are not introduced in addition to the lead proposal. Any changes should be reasonable and proportionate; implementing multiple changes simultaneously is neither of these. Should this option be implemented alongside the lead proposal, it is a further burden on business. From a business point of view, it's an unwelcome prospect.

Having said that, if it were implemented alone, **this option would be preferable to the lead proposal**. However, more detail would be needed to understand what compliance would look like.

15) If the government were to pursue this option, what checks should the client be required to perform?

There is a lack of clarity from the consultation as to what securing the supply chain would involve. For the supply chain option to be implemented there would be a reliance on other parties to provide information through the supply chain. The collection of this information could be burdensome for business, given the complex nature of private sector supply chains. There is uncertainty as to what level of assurance would be required to satisfy securing the supply chains sufficiently.

The administrative burden would be easier to meet for larger business than smaller ones. There may therefore be a case to exempt SMEs from the requirements.

Consideration would also need to be given to GDPR requirements and whether this proposal might conflict.

16) How should different views on employment status be dealt with? For example in the public sector, disputes should be resolved between the client and the worker, which ultimately allows either party to walk away if they do not agree.

In any business relationship the parties can walk away if there is an unresolvable dispute, but that is not a justification for introducing legislation that is very likely to cause disputes. Government should be trying to make it easier for businesses to engage contractors in a compliant manner, which is why the primary focus should be on the Employment Status consultation.

At a time when there is a focus on increasing productivity, why is the government proposing to introduce measures which are likely to result in relationship ending disputes?

Questions 17) – 24)

It is hard to answer these questions when there is so little detail provided about what the measure would involve. IPSE would gladly engage in a separate consultation on this option.

Additional record keeping – all questions

Similar to the previous option, it is imperative that this option is considered as a stand-alone measure. Any changes should be reasonable and proportionate; implementing multiple changes simultaneously is neither of these. Should this option be implemented alongside the lead proposal, it would be a further burden on business.

Most businesses (end clients) that IPSE has spoken to do not like this option. They see it as an unnecessary requirement to keep records that in most cases they will never be asked for.

Nevertheless, IPSE can see why this option might be attractive to HMRC who have the unenviable task of trying to gather records when conducting an IR35 investigation. We also think that this option is preferable to the lead proposal.

An alternative version of this option might be to place the record keeping requirement on the PSC. If liability were to remain with the PSC, it might make more sense to do it that way. This is not an agreed IPSE position, but it is an idea which came out of our focus groups, and may merit further consideration, but only if the lead proposal is dropped.

Other options to consider

Each of the four options which have been deemed 'out-of-scope' merit more consideration than the lead proposal, which for the reasons set out in the first part of this response, IPSE believes will have disastrous consequences. It is frustrating that government seemingly refuses to consider more imaginative ways to tackle the issue of disguising certain forms of work for tax purposes.

The world of work is changing rapidly. Government must be prepared to make radical policy changes in order to keep up. Tinkering around with IR35 will only heap more misery on businesses. IPSE would welcome the chance to assist policy making so that freelancing can continue to flourish while also protecting exchequer revenues.

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The Freelancer Limited Company

A new tailored entity for freelancers

September 2015

For discussion

Contents

Executive Summary	1
1. Introduction	2
1.1 The challenging role of the freelancer	2
1.2 Providing the right framework for the freelancer.....	3
2. What is a Freelancer Limited Company?	4
2.1 The premise of the FLC.....	4
2.2 The entry criteria	4
2.2.1 Single shareholder.....	5
2.2.2 An entity must be trading	5
2.2.3 Freelancers must opt into the entity.....	5
2.2.4 Minimum capital requirement.....	5
2.3 The operating criteria	5
2.3.1 Annual sign off of accounts	6
2.3.2 Incurrence of appropriate costs.....	6
2.3.3 Minimum salary requirement.....	6
2.3.4 General Anti-Abuse Rule	6
2.3.5 Dividend frequency restriction.....	7
2.4 Reversion to existing tax treatment where tests are not met on an annual basis.....	7
2.5 Retirement from the FLC	7
3. The tax treatment of an FLC.....	8
3.1 The choice of taxation options.....	8
3.2 Setting the tax rate	8
4. Conclusion	9
A. Issues with the current tax system	10
B. Number of self-employed people by occupation	11

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.

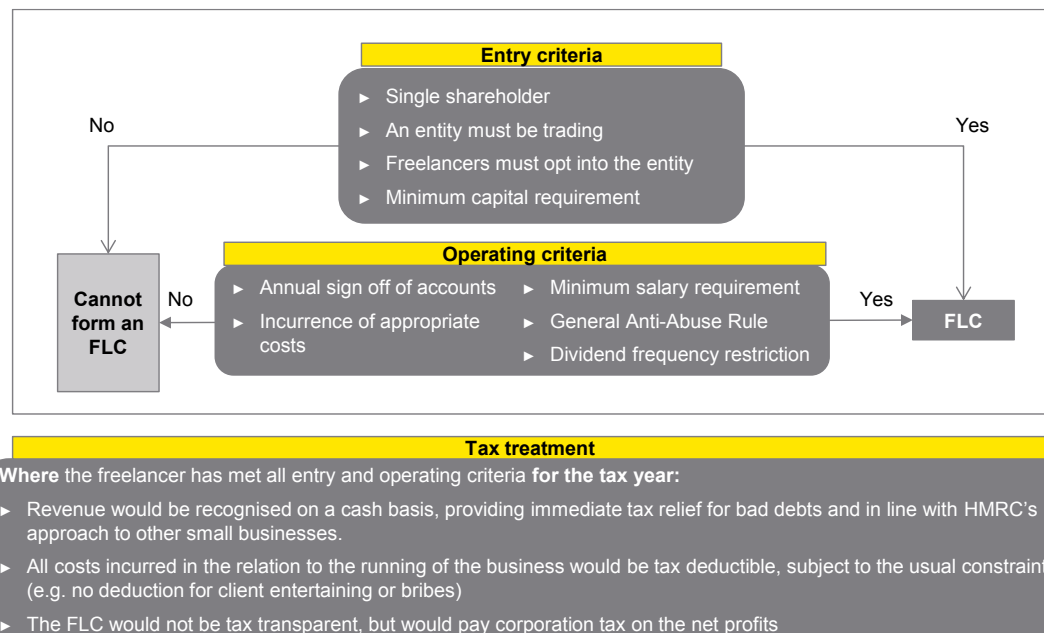
This would free freelancers from the perils of unnecessary and burdensome IR35 audits, allowing them to focus on the contribution to growth that their activities deliver. The FLC delivers this through a combination of:

- 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.



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.

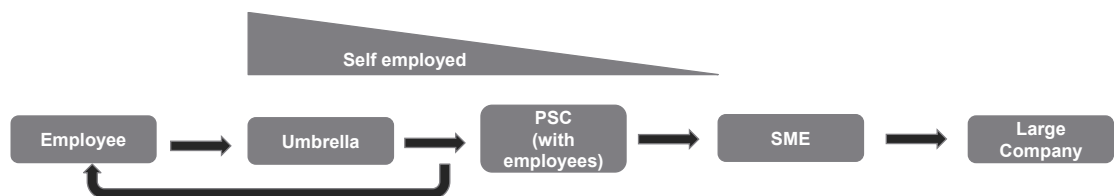
Similarly, freelancers can be differentiated from large companies in that revenue is generally based upon the individual's labour alone rather than a wider pool of profit-generating activity.

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.

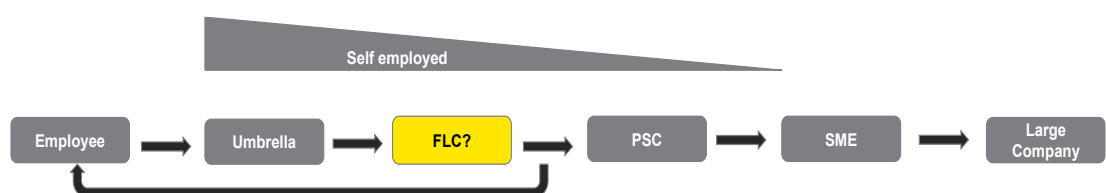
The options can be seen in the diagram below. This shows a common starting point for freelancers, of learning their skills as an employee and then moving away from employment into freelancing.



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.

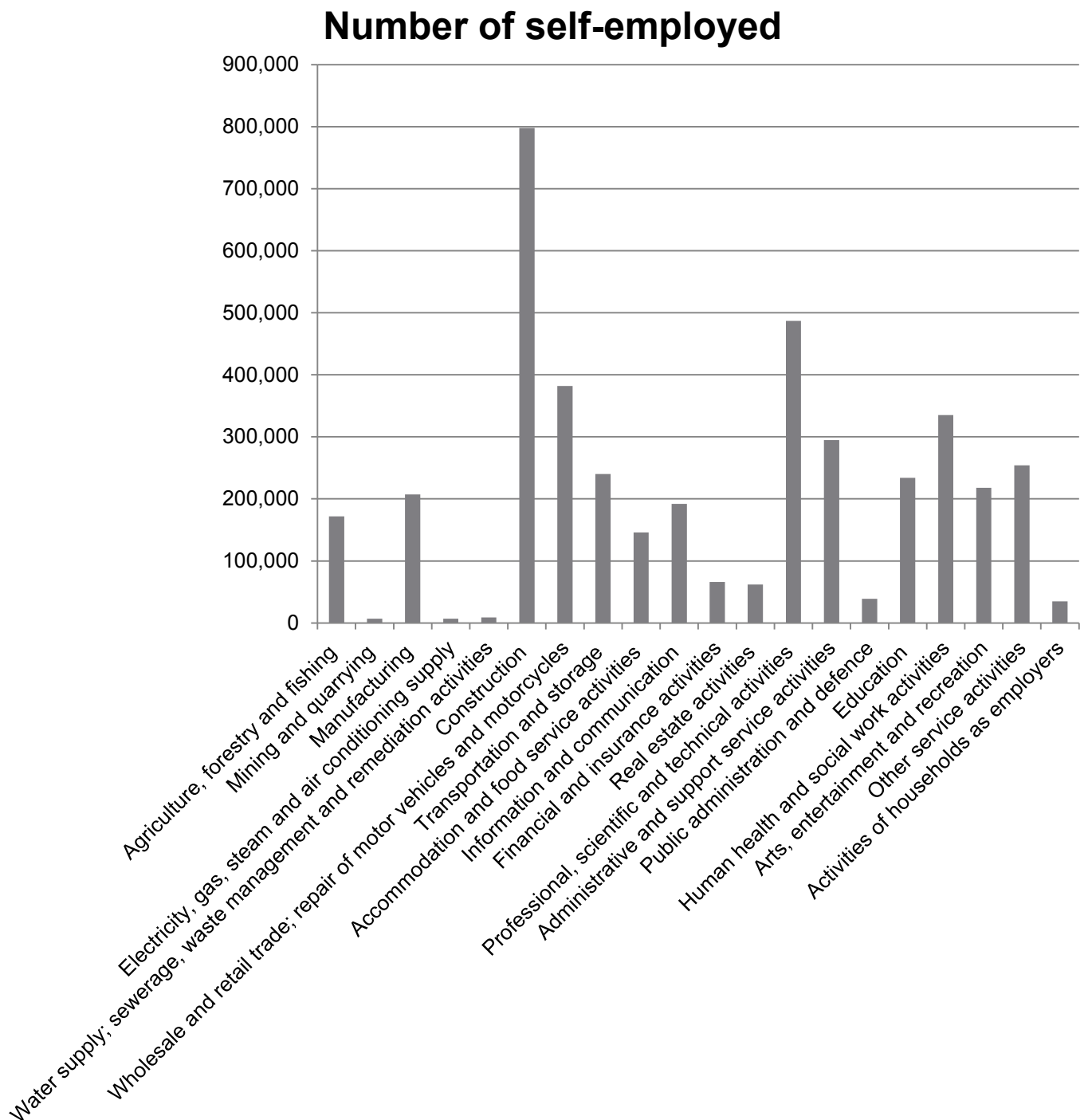
- The implications of an investigation

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.



The Association of
Independent Professionals
and the Self Employed

IPSE – IR35 OFF-PAYROLL LEGISLATION RESEARCH

JULY 2018



BACKGROUND, OBJECTIVES AND METHODOLOGY

BACKGROUND

Current IR35 legislation is designed to combat tax avoidance by 'disguised employees': freelancers / contractors using a limited company to trade when they would otherwise be employed by their client. It dictates that this type of freelancer / contractor has to pay the same amount of income tax and National Insurance contributions as if they were employed.

Currently in the private sector, freelancers and contractors are responsible for determining whether a contract necessitates the application of IR35, and are liable if their determination is wrong. Conversely, in the public sector, the liability of the application of IR35 is upon the client rather than the contractor. Recently, proposals have been made to amend the private sector legislation to bring it in line with the public sector.

IPSE commissioned ComRes to conduct qualitative research with business leaders responsible for engaging / managing freelancers or contractors in order to evaluate awareness and the potential impact of this proposed amendment to IR35 legislation.

OBJECTIVES

ComRes was commissioned by IPSE to conduct qualitative research with business leaders in order to:

- Determine the level of awareness of the proposals to amend IR35;
- Assess the degree to which private sector businesses are prepared for these changes;
- Find out business sentiment towards the changes to IR35 in the private sector;
- Investigate how private businesses currently use freelancers / contractors, and whether this will change if the amendments to IR35 are made; and
- Discover the expected impact of amendments to IR35 legislation on private sector businesses.

METHODOLOGY

ComRes conducted 15 in-depth interviews via telephone, each lasting around 30 minutes, between 21st June and 6th July 2018.

Interviews were conducted with business decision-makers in the private sector with at least partial responsibility for recruitment (including recruitment of contractors) and budgeting.

All respondents had recruited or overseen a freelancer / non-permanent contractor in the last two years.

Respondents were drawn from a range of sectors identified by IPSE where the use of freelancers / contractors is prevalent, and from organisations of a range of sizes, as outlined below.

Sector	Interviews completed
Manufacturing	5
Financial services	4
Engineering	3
Food and drink production	2
Pharmaceuticals	1
Total	15

Size	Interviews completed
Small	3
Medium	6
Large	6
Total	15

EXECUTIVE SUMMARY

IR35 LEGISLATION

- Among the business decision-makers interviewed, awareness of existing IR35 legislation varied greatly. Some were aware in name only, while others had a strong understanding, with confidence higher in the financial services sector.
- Awareness of the proposed changes to IR35 legislation in the private sector is low, with only three participants out of fifteen having a good level of understanding.
- Only one participant had made use of the CEST tool before.
- Most businesses were not particularly prepared for potential changes to IR35 legislation, with the exception of some financial services firms. Participants would like information and support to help them adapt to the changes. Some were of the opinion that the changes would not require that much work to prepare for, but this was not based on a strong understanding of the task.

IMMEDIATE IMPACT OF CHANGES TO IR35 LEGISLATION

- Freelancers were seen as very important to participants' businesses. They bring specific skills and allow businesses to meet deadlines and resource specific projects.
- There was a general sense among participants that making changes to IR35 was a good thing, in that they supported efforts to ensure that everyone pays their fair share of tax. A notable proportion supported the amendments as a result. However, most were less positive about the practical impacts of these changes.
- If the proposed changes to IR35 legislation were introduced, the biggest predicted immediate impact is administrative – businesses say they would have to put more effort into dealing with the legislation and checking contractors. This will require staff time and cost them money.
- Businesses also predicted an impact on finances – many say they would just have to pay the additional tax if IR35 was to apply. This would have a cost to the business and they would have to make savings elsewhere. Others said they would try to cut contractors' fees to compensate.
- Financial services companies were the least perturbed by the proposal. Most participants predicted a greater impact on smaller businesses: while smaller firms may use fewer contractors, the proportional impact was thought to be greater.
- A small number of participants felt that the changes would be beneficial to their business, as they would encourage them to be more efficient.

WIDER IMPACT OF CHANGES TO IR35 LEGISLATION

- Many respondents said that they would be more cautious about hiring freelancers due to the administrative and financial impact of changes to IR35. Some say they would hire permanent employees instead, although for others this is not an option.
- Many were concerned about their future ability to engage contractors due to them moving into permanent roles, or raising their rates and becoming too costly to hire.
- Most anticipated that such a lack of resource would reduce their ability to work effectively. However, others did not foresee a major impact on their ability to deliver, particularly in the financial services sector.
- While some participants did mention the possibility of moving business abroad, this was seen as a 'worst-case' scenario, and more likely to be driven by Brexit than by IR35. Most did not think it likely they would move business abroad.

AWARENESS OF, AND PREPARATION FOR, CHANGES TO IR35

Awareness of existing IR35 legislation is mixed, and awareness of the proposed changes is low. Most business leaders are not especially prepared for changes to IR35, but a fairly high proportion are supportive of the principles behind the proposed changes.

AWARENESS OF EXISTING IR35 LEGISLATION

Most, though not all, participants had at least heard of existing IR35 legislation, but a notable minority were aware in name only, and knew little or nothing about it. Others had a strong understanding of the legislation and its purpose, although many lacked confidence in their own knowledge. This suggests that even those who do understand IR35 see it as a complex piece of legislation. High levels of knowledge of IR35 often came from previous experience of working in a role dealing with contractors, or as a contractor.

"I have heard of it, but I'm not going to claim to know about it in depth, if I'm honest with you."

Large business, Engineering

"My understanding is rather limited, but I think HMRC wanted to reduce any grey area, so that the people who currently provide services through their limited companies, in future, I think they should be considered as employees of the company."

Large business, Financial services

"I think I'm much more aware of it than other people. I used to be an auditor by profession. I came across various situations where airline pilots were obviously doing this kind of arrangement on a long-term basis."

Medium business, Financial services

Awareness of IR35 legislation was higher among respondents in the financial services sector. This may be because financial businesses are more used to dealing with compliance and regulatory issues than those in other sectors.

AWARENESS OF PROPOSED CHANGES TO IR35 LEGISLATION

Awareness of the proposed changes to IR35 was lower than awareness of existing IR35 legislation. Despite all participants being involved in hiring or managing freelancers / contractors, some respondents were not aware at all that the legislation was changing, and expressed surprise about this.

"It's new to me. When does that come into place?"

Large business, Manufacturing

Others were vaguely aware of some kind of changes to contractors' rights, but not in any great detail, while a few participants were aware there could be changes, but not of all aspects of what could change. Some also had misconceptions over what the changes would entail (for example, one respondent thought that there would be a cap on the number of months a company could engage a contractor for, before having to treat them as an employee).

"I heard about the recent discussions regarding people's long-term contracts, and them gaining the same rights as employees... I haven't heard of it [the proposal]. I haven't been fully made aware of the kind of the liability being placed upon us."

Medium business, Manufacturing

"I think there are certain hard and fast rules there... I'm not sure when they're coming into play... We're trying to go down the route of not having a contractor for eighteen months, and then re-looking at really seeing whether we still need them longer than that. If we do need them, they might need to take a break before they can carry on working."

Large business, Pharmaceuticals

Only three participants displayed a strong awareness of the proposed changes, two from the financial sector and one from the food and drink sector.

"I've been aware of it, and then I went to a Deloitte briefing where they touched on the fact that this is something that may eventually lead to the private sector from the public sector... It's all about, shifting that burden or that responsibility for making that assessment."

Medium business, Financial services

THE CEST TOOL

Awareness of HMRC's Check Employment Status for Tax (CEST) tool is low. A few respondents had heard of it but not used it, while most had not done either.

One respondent had used the tool before and said that it was useful, as it was free, clear, and walked them through the process of assessing tax status without having to speak to someone.

"Yes, I've used that. It's good. I used it because I had my concerns. I was aware of the legislation [and] wanted to check that my understanding was correct without speaking to a person. I thought that was a very clear way of being able to do it, so I did that and found it extremely useful."

Medium business, Financial services

After being told about it, most participants said that they would use it if needed. This was mainly based on the tool sounding like it would be useful, and was not a particularly strong sentiment. The fact that it is recommended by HMRC was also a plus for some. A few respondents commented that the tool would only be worth using if it is accurate. Others felt that it sounded like it could be useful, but only to other functions within their business.

"I mean, if it's recommended by HMRC, and it's an available tool, then I'd definitely use it, but I would also bear in mind that it's only accurate in 85% of cases."

Small business, Manufacturing

"No, I haven't really had much need to use it, but I have heard of it. I'm sure our accountant uses it for us."

Medium business, Manufacturing

"I think it's one of those tools that if you use it, it's find that it's actually not accurate, then you think there's no point using it."

Medium business, Manufacturing

PREPARATION FOR POTENTIAL CHANGES TO IR35

As a result of low levels of awareness of the potential changes to IR35, the majority of participants were not particularly prepared for these. The exception was in the financial sector, where a number of participants (particularly those from large businesses) were already well-prepared for the potential changes.

"Yes, having this conversation has made me realise that we probably haven't thought about it as much as maybe we should have, so it's definitely something we'll be having a think about, because I think we do need to be prepared. We don't want to get caught flat-footed on this... we haven't really thought about it that much, to be honest, so we need to."

Large business, Engineering

"Well, IT systems are pretty good. We're up to scratch with everything. I daresay my office manager would be even more aware of it than myself because he keeps abreast of all these things and we do have monthly meetings where we discuss any new things that may be coming. Any problems we'd encounter so I daresay we could incorporate it quite easily."

Medium business, Food and drink production

Most participants felt that they would need information and support in order to adapt to these changes, with a number saying that they would seek professional support.

"Yes, I would imagine we would want some level of guidance. It's a Government organisation introducing this... I imagine they would be providing some kind of feed-down system of information. We've got our solicitors who would probably look into it for us. I imagine there's probably going to be a pool of resources we can tap into."

Medium business, Manufacturing

"I would have to reach out to my accountant to provide me with advice and, obviously, that's another cost."

Small business, Financial services

Among those who were not prepared for the potential changes, some participants were relatively optimistic, and of the opinion that they did not think it would be particularly complex or require that much work for them to prepare for. However this was not based on any real understanding of the task at hand, suggesting that some businesses are unaware of the potential scale of adaptation required.

"Again, this is just an assumption, but I wouldn't think there's a lot that we would need to do to comply. I may be completely wrong. I think it would just be a case of making sure there's a paper trail and being on top of the administrative side. Other than that, I can't really think what else I'd need to do to comply."

Small business, Manufacturing

SENTIMENT TOWARDS POTENTIAL CHANGES TO IR35

Almost all business leaders reported that they would experience some degree of negative impact, either immediate financial or administrative burdens or more broadly in terms of how freelancers and contractors may operate long-term within their companies. Despite this, overall sentiment towards changes towards IR35 off-payroll legislation was mixed, with a fairly high proportion of respondents being supportive of the changes.

Some saw it as an effective way to tackle tax avoidance and others saw it as a way to level the playing field – both for the non-contractor who may be on a lower salary than a contractor doing the same job as well as giving National Insurance benefits to freelancers. There was also a moral dimension to how some people viewed the legislation with some seeing it as the right thing to do.

"From a greater good point of view and viewing it from HMRC, I can imagine it is better to put things through the employer. Chances are everything is going to be a bit more above board and relevant checks and payments are going to be made... I think it's a good idea."

Medium business, Manufacturing

"It seems like to me, it's going to be fairer for everybody in terms of taxation...it's more of a level playing field... [with] less deviance going on."

Large business, Engineering

"Well... I am employed as a PAYE employee, and I pay all of my PAYE tax, National Insurance, and I think it's unfair when someone can do more or less the same job as I do, and they save on taxes. So, I think it would be fair."

Large business, Financial services

"Morally it's the correct thing to do. However, thinking from a commercial point of view... I do think it could potentially have major consequences for organisations."

Medium business, Engineering

Two business leaders saw the changes as a positive thing because, even though there would be a financial cost to their business, it would have a positive impact in terms of people's awareness of how freelancers operate and make companies more effective in how they use freelancers.

"I think change is good in the sense that, even if it's the wrong answer, it will bring awareness... there will be a conversation, one hopes, off the back of a change."

Medium business, Financial services

"I think this will certainly help us really focus and look at our resourcing needs in a bit more detail."

Large business, Pharmaceuticals

There was discussion in some interviews about whose responsibility it is to sort out the tax affairs of freelancers, and no clear consensus on the issue. Some felt it should be down to the company, who may have more experience and resource to deal with IR35 compliance. Others agreed it should be the responsibility of the individual freelancer who chooses to work in that way.

"It should be down to the employee or the contractor to manage their own tax affairs. They're ultimately liable for it, so why would the business be required to incur costs for doing that if it is not their responsibility."

Large business, Manufacturing

"I think it's possibly a good thing, because obviously it will take it off the employee's head and put it on the company, who probably has a lot more money for dealing with IR35 and its compliance."

Small business, Financial services

There was generally a lack of knowledge around how far tax avoidance through 'disguised employees' is a problem in the UK. Opinion among business decision-makers was divided in this area. Some were unsure of how much of a problem disguised employment is, or saw the changes to IR35 as targeting the wrong people. However, others saw the changes as potentially a good way to ensure everyone is paying the right amount of tax, regardless of how widespread the problem is.

Some respondents were unsure whether changing the legislation would be worth it given the perceived scale of the problem and the administrative burden and compliance on companies, but others were more supportive.

"I think it's taking a hammer to crack a nut, I think it's not the right way to do it."

Medium business, Manufacturing

"I think it's a bad way. It's just adding an administrative burden that companies won't want... I want to know how rife it [disguised employees] is at the moment to know."

Medium business, Food and drink production

"It needs to be sorted out, tax avoidance, but it just makes me think sometimes are they going for the right people?"

Large business, Engineering

"I think it's a good way, because obviously you're getting some people that escape the net... I don't know the percentages, but I don't think there's a very high amount that try and avoid taxation."

Small business, Financial services

"If it's structured, yes, I think it will be effective."

Large business, Financial services

"I suppose the only positive thing I can think is that the few people who do manage to avoid paying their taxes as they should, well you'll catch them. Whether that, in the end, makes much of a difference, I don't know."

Medium business, Manufacturing

IMMEDIATE IMPACT ON BUSINESSES

Freelancers are seen as highly beneficial to the businesses that engage them. Business leaders predict the potential changes to IR35 will have a negative impact in terms of an increased administrative burden and financial cost.

THE BENEFITS OF FREELANCERS

Business leaders' engagement with freelancers varied widely by business size and sector but one aspect that came through across the sectors and business sizes was the value that freelancers bring to businesses. This ranges from providing specific expertise to fresh ideas and different perspectives and ways of working that full-time employees may not have thought of.

"We like using freelancers because... they have fresh ideas. They don't automatically think from our company's point of view."

Small business, Manufacturing

"We would use freelancers or contractors for a specific purpose, project or task that needs to be completed where... there's a specific skillset that we don't have."

Large business, Manufacturing

"We need their expertise, and it would be very expensive to hire them otherwise because usually [their] hourly rates or even daily rates are very high."

Large business, Financial services

Using and engaging freelancers was seen by many as crucial to business success and smooth operations, for example by allowing businesses the flexibility of meeting deadlines or working on specific projects for a short period of time.

"We use a high volume of contractors really to help with... peaks and troughs in terms of volume of work."

Medium business, Financial services

"The advantage [of hiring freelancers/contractors] is the flexibility and the ease."

Medium business, Manufacturing

"We couldn't function without a few of them, that's for sure."

Large business, Engineering

FINANCIAL AND ADMINISTRATIVE BURDENS

As a result of this, most business leaders felt that implementation of the suggested IR35 legislation would have some immediate implications on the way their business works. Generally, business leaders

said that they would need to assess each freelancer they currently work with to understand whether or not IR35 legislation applies.

For companies which hire many freelancers, this would be a substantial time commitment and administrative burden. Smaller companies, while typically engaging fewer freelancers, would also struggle, often due to not having the resource to deal with the administration or increased cost.

Further, business leaders highlighted the financial and administrative burdens that IR35 legislation would place on their business. These two factors often went hand in hand i.e. the cost of hiring people full-time to sort out the administrative processes needed.

"[IR35 would] cost us more to employ people... but it also might have an effect on the manpower and the specialisms."

Large business, Engineering

"The administrative burden and the people's time in doing this is a financial cost in the end, as well, if that makes sense."

Medium business, Manufacturing

"More red tape and more cost."

Medium business, Food and drink production

In one financial services company which had already changed the way it hires freelancers in anticipation of IR35 legislation, a cost had already been seen through hiring four new employees to undertake the work of making sure they would be compliant if the new legislation came through.

"It's definitely had some financial impact... there are some people's time involved... [and] the training cost... and data protection... [the company] has suffered already financially."

Large business, Financial services

Most business leaders, with a few exceptions, said that they probably would pay the National Insurance contributions if it was determined that IR35 applied, as it would be part and parcel of complying with the legislation. However, they highlighted that the extra cost to the business as a result would have a substantial impact and the need to make savings elsewhere so as not to negatively impact on companies' profit margins.

A few would seek to cut a freelancer's fee or negotiate as the result of this to attempt to mitigate the cost to their business. One or two also mentioned the further cost of auditing and accountancy fees or the need to consult a third party to help them become compliant if IR35 legislation was to come into force.

"Our view [on National Insurance] would be [saying to the contractor]: 'This is what we're willing to pay for you. If there's an NI cost on top of that you're going to have to reduce your fee to us, because we're not prepared to take that hit.'"

Medium business, Manufacturing

"Well, I think it's another thing for you to have to consider through payroll. It's another thing that we'd potentially be audited on. It just seems like unnecessary"

paperwork to notate. Especially as sometimes we might only have somebody for a day or two."

Medium business, Manufacturing

"I would have to reach out to my accountant to provide me with advice and, obviously, that's another cost. It's not free... it's just an extra burden, all these rules and regulations that actually don't make sense."

Small business, Financial services

That said, a few business leaders did not believe that changes to IR35 off-payroll legislation would have a great deal of impact on their business, either because of the sector they work in or because of the way their company operates with certain freelancers. Others were resigned to the legislation as part and parcel of doing business. Along a similar vein, one or two found it difficult to articulate the extent of immediate impacts on their business – this may be the result of a lack of knowledge around IR35 legislation generally which meant that potential changes were difficult to predict.

"I don't think a great deal because whatever is decided will have to be abided by."

Large business, Engineering

"For our key operations team, I don't see there being a great deal of impact because those that contract are on three to six-month contracts, I'd be surprised if they started to get caught by it. Pretty much all of them work through agencies anyway, so I don't think there are any personal service companies in operation that I use."

"I think there's more to worry about in terms of the current climate than that change in legislation, so I can't see it having an impact, if I'm honest with you."

Large business, Engineering

"Overall for us [the financial services sector], the impact is limited. Very limited. Clearly, if I was to move industry, then I would expect that to be nuanced in a different way."

Medium business, Financial services

DIFFERENCES ACROSS BUSINESS SIZE AND SECTOR

There were variations in business leaders' perceptions of how far the legislation would impact on their business. Although these differences were based on a small number of interviews, and therefore should be treated as indicative, participants from smaller businesses tended to indicate that the financial cost of complying would have a greater impact on their companies when compared to larger businesses. This was because larger businesses are seen to generally have more resource available to become compliant compared to small businesses, and that any cost incurred would have a greater impact on a small company's overall bottom line and profit margins.

Particularly within financial services or other larger/client-facing businesses, who are well acquainted with compliance issues and also may be able to pass the cost of specific freelancers on to clients, this was seen as a "drop in the ocean" when compared to other potential changes, such as GDPR and Brexit. That said, even in companies who are generally well prepared for compliance changes or would pass on

costs to clients, costs for internal projects would still produce a financial burden, and the increased project costs passed on to their clients would likely have an impact on the private sector more generally.

"Well, I think, probably in my industry that [National Insurance Contributions], would be passed on to the client."

Large business, Engineering

"We'll pass this additional 13% to the clients. So, hopefully it wouldn't affect us as much, but for all the internal projects, that would be an additional cost... We work under strict budgets, this additional cost would need to be added to the budget and savings must be made elsewhere, although that would be very difficult, so we may reduce the number of employees, or number of internal projects... It would have an impact on whether we could compete with our competitors on price."

Large business, Financial services

Larger companies were generally of the opinion that SMEs would be affected more greatly by the change in legislation.

BROADER CONSEQUENCES

Beyond the immediate financial and administrative impact, business leaders identify broader consequences that may arise if IR35 legislation is amended, such as changes to hiring practices, contractor rates and resourcing, and strategic relocation.

HIRING PRACTICES

Many respondents across a variety of sectors said that they would be more cautious or hesitant in employing contractors and freelancers when asked about the potential impact of IR35 proposals on their hiring practices. This was usually as a direct result of either an anticipated administrative burden or financial impact.

"If [contractors are] raising rates to compensate, then it would have a direct impact on the number of contractors we'd employ."

Large business, Manufacturing

"I would think to myself, 'Well, hold on. What is this actually going to cost me?' where before I never thought of that. Before if we needed staff, we had to get them but now maybe I would think a little bit... can we struggle for maybe the month and without the extra cost? I would maybe then do a feasibility study."

Medium business, Food and drink production

"If I have a greater responsibility because of [changes to IR35] I would probably think twice or be more hesitant and reluctant to hire out a freelancer, because it may work out being more of a headache than it should be. The whole point of me hiring a freelancer is because it sounds simple to just hire someone for a couple of days but if IR35 comes in and it means more paperwork, then I may want to avoid it."

Small business, Manufacturing

"I think obviously there may be less contracting jobs about because of all these extra regulations."

Small business, Financial services

Some business leaders took this further, and reported that they may be inclined to hire permanent employees in the place of freelancers, based on their prediction that a number of contractors will move into permanent work, or simply because they are more familiar with simple hiring processes for full time employees.

Actually, I think the market will just change slightly, and you might get a few more contractors wanting to go permanent, and therefore companies such as ours, and maybe clients, will look at taking on permanent staff rather than contract staff. The shape of the market might change slightly, but as I said, it will depend on the contractor.

Small business, Financial services

"[Changes to IR35] would reduce the benefits of having a contractor. If the amount of paperwork involved and the amount of legislation and risk to the business is higher, then for lower paid work, it would probably be easier just to get a full-time employee. It's a process we're already familiar with."

Large business, Manufacturing

"I think we just need to be a bit more smart in terms of our resourcing needs and really define if there is that need to bring [a contractor] into the business, or we can look at maybe a permanent resource."

Large business, Pharmaceuticals

This response was not as common amongst business leaders working within the manufacturing or engineering sectors, as they typically rely on short-term, cost-effective expertise for their essential business functions on a project-by-project basis. Similarly, those working in volatile markets emphasised the significance of contractors in managing workload fluctuation, making a significant movement towards hiring permanent employees as a replacement for contractors unlikely or risky in such industries. Consequently, these businesses report that they will simply have to bear any administrative or financial burden caused by hiring contractors.

"I think contracting would be the only way forward, so I don't think it would change in terms of numbers."

Medium business, Manufacturing

"The kind of contractors and self-employed that we use, there's no need to have them as permanent staff. We use them as ad hoc specialists."

Medium business, Manufacturing

"Within the automotive industry, where I work, it's peaks and troughs. When we hit a peak, we would struggle [only using resource from other company plants]. We wouldn't be able to keep our production rates where they need to be. I'd sooner stick with contractors... but at the end of the day it's what the CEO of the company wants... [they might decide that it's] too costly and too much to maintain [contractors]."

Large business, Manufacturing

"Do we try and recruit people as permanent staff, looking ahead, just so we have these people? But it's hard, isn't it? You might not end up winning a project, so you've got these people twiddling their thumbs, you might not have something for them to do, so that's another thing why we use a lot of contractors. I think that's probably the main thing."

Large business, Engineering

CONTACTOR RATES AND RESOURCING

A prominent concern for business leaders across a variety of industries was the potential for a lack resource and expertise as a result of IR35 amendments. This concern often stemmed from the belief

that, in an effort to off-set or avoid increased taxation, contractors may move into permanent roles or raise their rates, becoming too costly to hire.

"Potentially on us [the biggest impact] it's the limited resource available."

Medium business, Manufacturing

"It's going to maybe cost us more projects, cost us more to employ people, but it also might have an effect on the manpower and the specialisms. If these contractors are charging more, we might be put off taking them on, so we're going to lose out. Manpower and cost are definitely the two main things... because we do need these people."

Large business, Engineering

"I think a lot of people that operate within that industry like the freedom to be self-employed. I think as a consequence it might make people either retrain and go into a different route or it could dilute the workforce that you've got potentially...that might put off future people going training in that industry. I think it will make people think twice. The next generation of people coming through might not necessarily go through and it could result in a shortage within the industry."

Medium business, Engineering

"For contractors who go from company to company, this works for them, but if you suddenly took that window of opportunity away, the skills set and the resource level would completely drop, wouldn't it?"

Large business, Manufacturing

Anxiety and uncertainty around Brexit further complicates this picture for some businesses, as the potential depletion of foreign freelancers and contractors may exacerbate a lack of resource.

"If we're looking at overseas skilled work, then it will make things more challenging to get people if you have to apply for visas and things. I'm not, you know, fully aware of the implications at this stage."

Large business, Manufacturing

"Yes, I think it's an additional layer of complexity because we do [have to] prepare for Brexit although it's very vague, and on top of that we have to consider the new legislation. [But at the moment] we don't have much to discuss because it's still a very fluid process."

Large business, Financial services

Notably, many respondents across a variety of sectors anticipated that the lack of resource that may result from changes to IR35 could simultaneously reduce the quality or speed of projects, and increase prices for clients.

"If it came into play, it would be the administrative work and the reduction in contractors, meaning we have fewer skilled people around us to get the jobs done. So, the business would be impacted by longer timescales to complete projects... it would be more difficult to resource the required skills and slow us down."

Large business, Manufacturing

"I feel it might limit the pool of resource that are available to us, and also the additional cost of then us having to perform any necessary check inevitably adds to either delays or increase costs to our customers. I think the cost of most things would be increased, so using CPI indices and things... ultimately the customer [is] going to end up footing the bill for any increased taxes."

Medium business, Manufacturing

"It will bump up the cost of hiring someone, and it will just be more of a cost to the business, which then impacts the type of work and the quality of work you've done, because you may feel as if you can't hire as many."

Small business, Manufacturing

However this prediction was not universal. Those working in the financial services industry in particular were generally not as concerned for their industry, citing the resilience of the sector in dealing with regulation and compliance.

"I think there's a lot happened in the financial services sector, you know. You look at Brexit. You look at the BSR. There are a lot of regulations coming in, and the financial sector is fairly resilient. Anything comes in, people take it in their stride. The FCA and other types of bodies, they make sure you're compliant. So, is it going to affect? Probably not. It might make people slightly more aggravated, but I don't think it will affect it too much. I think it would probably adapt quicker than maybe other sectors."

Small business, Financial services

Other business leaders believed that the overall impact on the private sector would not be significant, as rising prices are a natural element of their sector economy. Although this formed a minority opinion from the respondents interviewed, this is notable in confirming that there is still a great deal of uncertainty and disagreement amongst business leaders regarding the potential impact of IR35.

"If it's a big client, they'll pay the money to get the work done. So, the contractors turn up to do the work at whatever rates are currently in. I don't think it's going to change. In general, in my industry, it's not going to change because people are going to be queueing up for work when it's busy and, you know, being laid off when it's not there. It's just cyclic. So, it's not really going to change."

Large business, Engineering

"The private sector as a whole, I'd say is possibly going to be less affected than any public service sectors. I think private, they have the opportunity to manage their bills and employments a lot more freely with other people, so agreements are a lot easier to make. I personally believe in private industries and negotiations. I can't see it having a huge impact. Prices may go up or increased services and maybe more people moving towards permanent employment, which may not be a bad idea."

Medium business, Manufacturing

MOVING BUSINESS ABROAD

Business leaders paint a complex picture when it comes to their future strategic intentions in the context of IR35 and Brexit. Despite reporting a variety of wide-ranging concerns with the IR35 proposal, moving business abroad was considered a 'worst-case' scenario, with many respondents stating that they either have no intention of doing so or that they are restricted to the UK by existing infrastructure or regulations.

"I don't think [moving business abroad] would be beneficial because a lot of our work uses electrical compliance in the UK, so once you go out of that remit there are obviously different regulations."

Medium business, Engineering

"I don't think [we would move business abroad], just because of our stature. I think there's more to worry about in terms of the current climate than that change in legislation, so yes, I can't see it having an impact."

Large business, Engineering

"If this was going to massively impact us, then, you know, we might feel there's the need to move some of these positions to the US. However, saying that, a lot of our headquarters for some of our specific groups are here in the UK. So, you know, from that point of view, it can only be a limited number of things that we can move."

Large business, Pharmaceuticals

A few business leaders toyed with the idea of focusing their business efforts beyond the UK, although this was usually conditional on how Brexit uncertainties will ultimately be resolved, and the actual impact that IR35 would have on their business should the proposal be implemented.

"On large projects, they'll push a lot of work out to cheaper centres, and get work out to high-value centres in India and Jakarta and places like that. [If] costs for the UK go up and become untenable, then ... a large percent of [the work] will be pushed out to other global sites, with cheaper centres and a different tax regime."

Large business, Engineering

"It's just this 'unknowing' for British industry here. We've got Brexit. Businessmen like to have a clearer picture and that way they can grow their businesses with a clear idea of what the future is going to behave like. I know none of us have got a crystal ball but as I said [this] just seem to be making ways of making it more difficult for the small to medium businessman."

Medium business, Food and drink production

CONCLUSIONS

SUBJECT	RESEARCH FINDING	CONCLUSION
Knowledge of IR35	Even among those who regularly engage and work with freelancers, detailed knowledge of the rules and regulations around how they work is limited.	If the rules are to change in a way that requires businesses to adapt, they will need to be informed of how to deal with these changes and supported in adapting to them.
Sentiment towards potential changes to IR35	There is general agreement with the principle of making it more difficult for people to minimise their tax bill , and ensuring that everyone pays their fair share of tax. A number of participants expressed support for the changes as a consequence.	Business leaders are not opposed to measures to ensure fairness in the tax system, and think that the principles behind the proposed change to IR35 legislation are sound.
Impact of potential changes to IR35	Views on the impact of potential changes to IR35 are mixed, but overall they are seen as having a greater negative than positive impact:	<p>The proposed changes to IR35 legislation are likely to have an overall negative impact on UK businesses.</p> <p>Those who can take the option of using fewer contractors will still face issues with reduced flexibility and ability to respond to peaks and troughs in demand.</p> <p>Those who do not have this option are likely to see increased costs, and face greater difficulties in engaging contractors.</p> <p>In both cases, this is likely to lead to reduced business efficiency and productivity.</p>
	A couple of participants felt that the changes would be beneficial to their businesses, and make them more efficient.	
	Some participants, particularly those in the financial sector, felt that the changes would not really affect their day-to-day operations , as they would be able to ensure compliance without much issue.	
	<p>The majority of participants felt that changes to IR35 would have some negative impact on their business, principally:</p> <ul style="list-style-type: none"> • Greater tax and administration costs. • Reduced ability to engage freelancers. • Reduced ability to deliver high-quality projects. 	

THANK YOU

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Collated IPSE and CIPD research into IR35 reforms in the public sector

IR35 in the public sector: what does the evidence say?

Changes to IR35 in the public sector have had a severe impact on the ability of public sector bodies to access skilled resources, particularly in the NHS, with a rapid rise in projects being delayed or cancelled. They have also prevented independent professionals from working freely in the public sector. These are the clear conclusions from two separate surveys recently conducted by IPSE and the CIPD.

Methodology

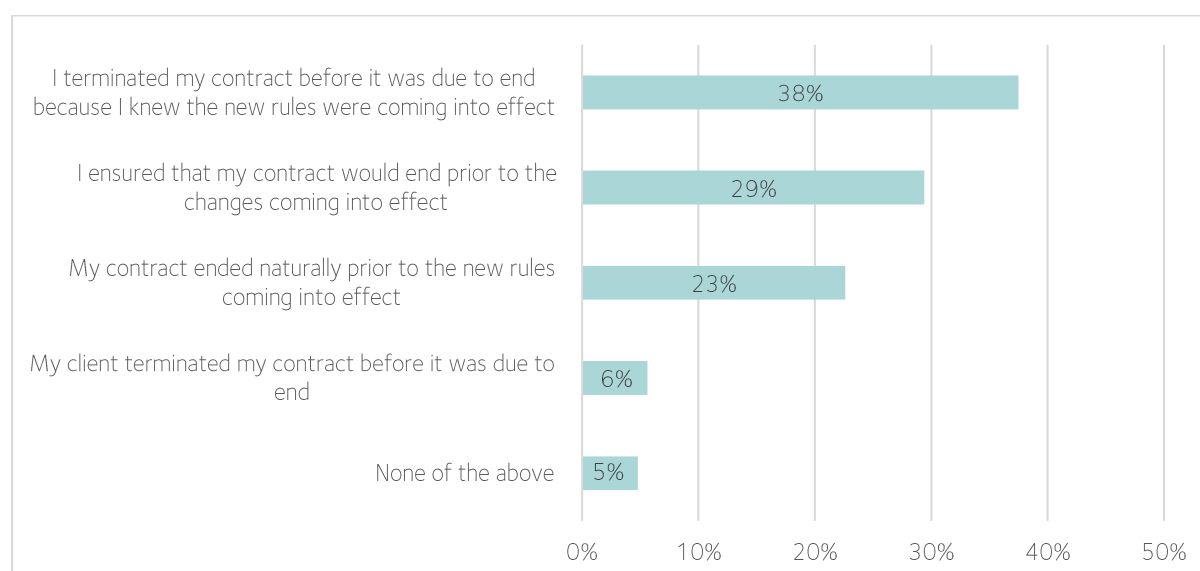
This summary is based on the responses to a series of questions about the change to the off-payroll rules in the public sector, as part of a survey conducted by IPSE in partnership with the Chartered Institute of Personnel and Development (CIPD). The data was collected via an online questionnaire between 22 January and 13 February 2018.

IPSE's survey results are based on the responses of 1,290 contractors working in the public sector. CIPD's results are based on a sample of 115 hiring managers, 84 per cent of which are NHS trusts.

Access to skilled resources hampered

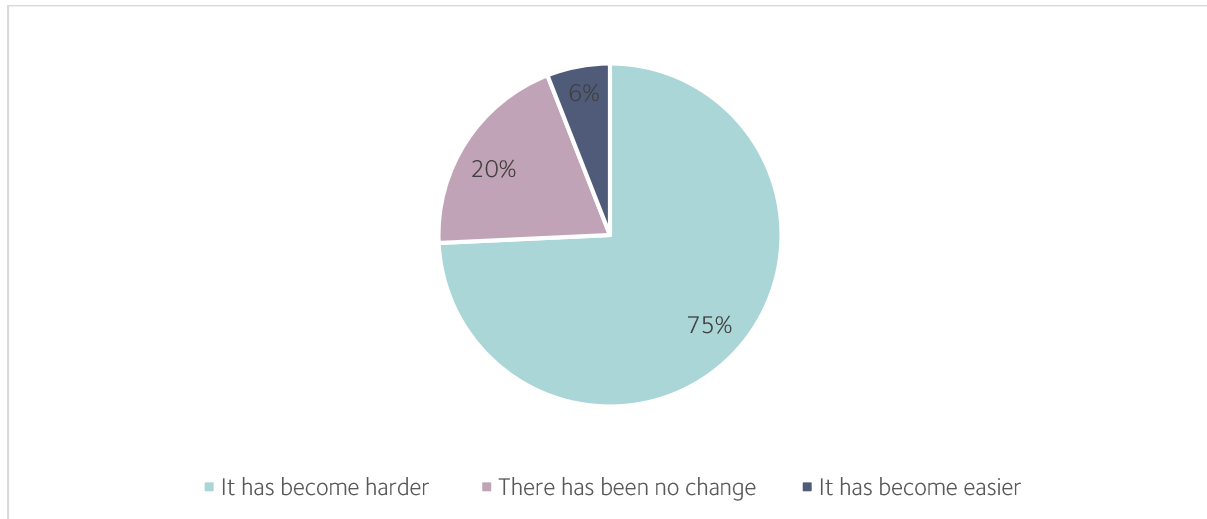
Almost a third (31%) of respondents to IPSE's survey said they had been working in public sector prior to the change but were not afterwards. Over two thirds attributed this to the change to IR35 rules in the public sector.

Figure 1: Which of the following, if any, best describes why you were not working on a public sector contract on or after the 6 April 2017?



This is backed up by what hiring managers reported in CIPD's survey. Since the change, 75% say it has become harder to recruit contractors, while retaining contractors has been a problem for 71% of hiring managers in the public sector.

Figure 2: What impact, if at all, has the change to the way the off-payroll rules in the public sector are applied had on your organisation's ability to recruit contractors? Please select one of the following options.

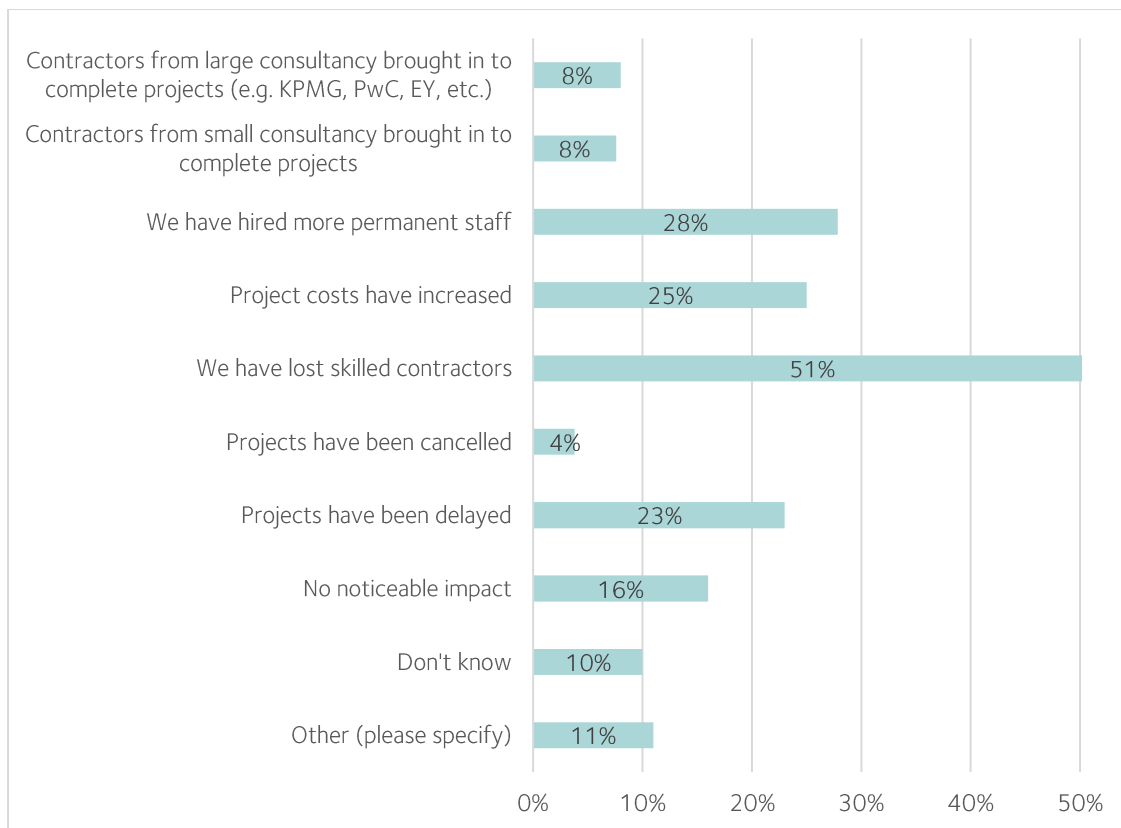


Projects delayed & cancelled

Inevitably after losing this skilled resource, public sector bodies have struggled to deliver complex projects. There have been well-publicised stories in the media of delays to repairs of London Underground lines and shortages in the NHS as a direct result of this change to IR35.

Freelancers in the public sector have noticed the impact, with 40% witnessing delays to projects and 35% higher project costs. Hiring managers themselves echo this concern – over half (51%) have lost skilled contractors with 52% experiencing delays, cancellations or increased costs as a result of the change. One key reason for the increased costs is likely to be an increasing reliance on large and expensive consultancies to complete projects.

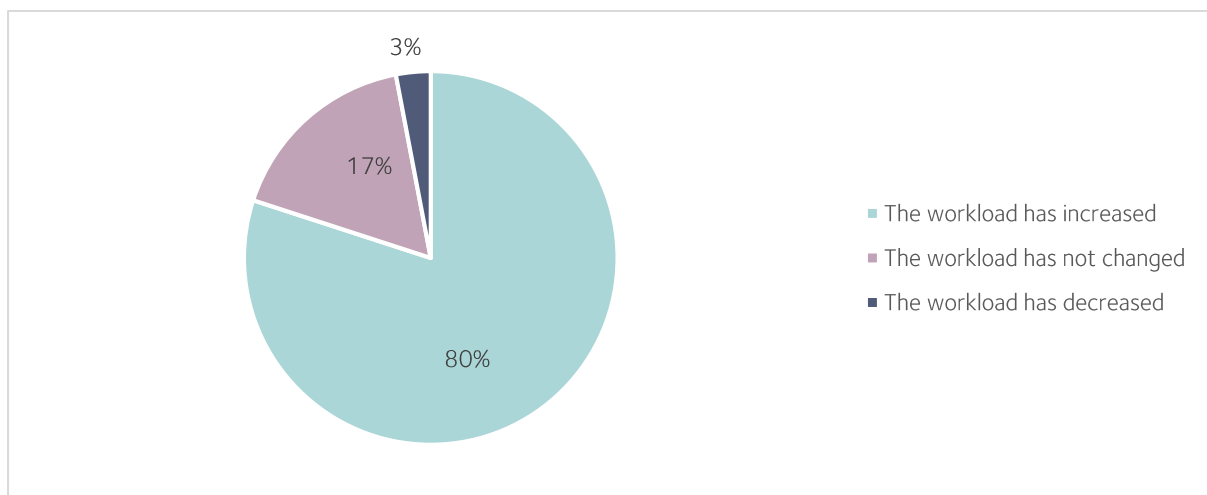
Figure 3: Which of the following effects, if any, has the change to the way the off-payroll rules are applied had on your organisation? Please select all of the options that apply.



Increased admin burdens for engagers

It's not just the material effect on freelancers and the public sector bodies that need to engage them that have caused problems. Public sector bodies have seen huge additional administrative burdens as a result of having to assess each individual engagement. Indeed an overwhelming 80% of hiring managers say the workload around engaging and paying contractors has increased.

Figure 4: Since 6 April 2017, has the workload associated with engaging, assessing and paying contracts changed? Please select one of the following options.



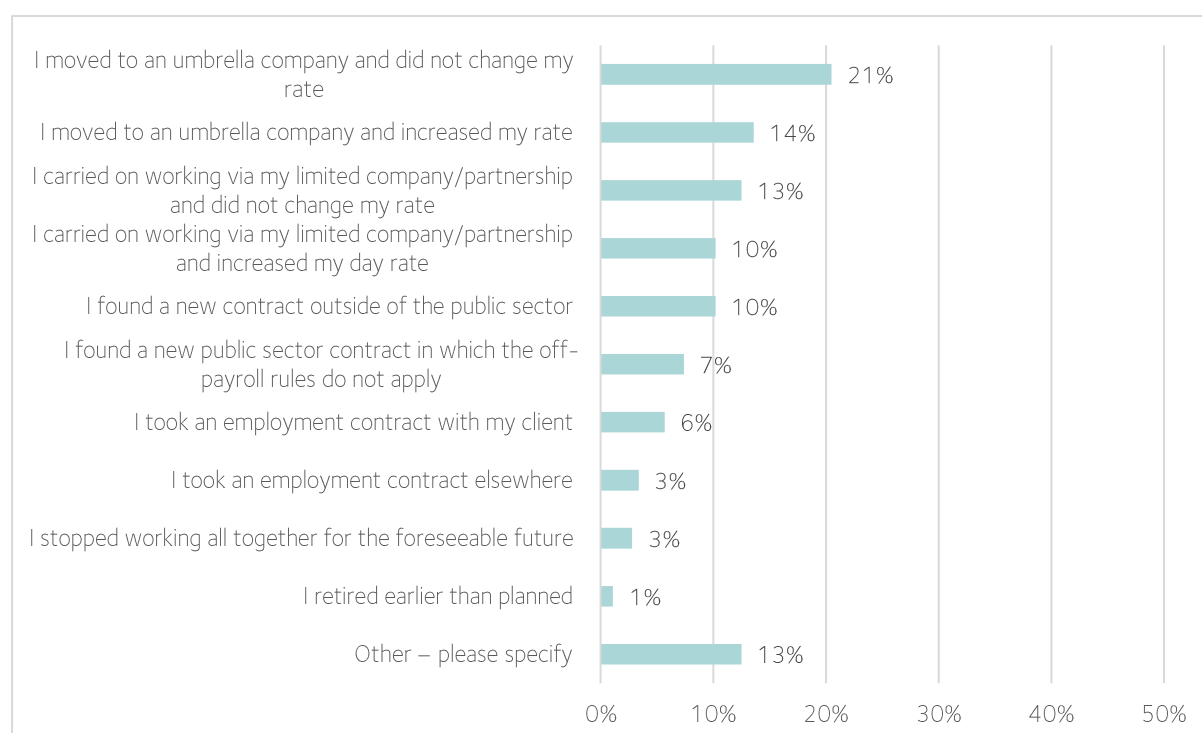
Inevitably public sector bodies have struggled to deal with this additional burden. Independent professionals have found that their public sector client often does not have the expertise or time to assess each engagement individually, instead making a blanket decision that all engagements fall within IR35. Only just over half (55%) of the hiring managers reported assessing each engagement individually.

What happened to those freelancers found to be inside IR35?

Aside from the large numbers of independent professionals who chose to curtail their engagements in the public sector, for those freelancers who continued and where it was determined that the off-payroll rules applied to their engagement, the highest proportion (35%) moved to an umbrella company. Only a quarter (23%) carried on working via their own limited company/partnership.

A further 10% found a new contract outside of the public sector after their client determined that the change in the rules applies to them.

Figure 5: You said that your client determined that the off-payroll rules applied to your engagement. Which of the following options, if any, best describes what action you took as a result of that determination



What does the future hold?

IPSE will urge policymakers to consider closely the data from these surveys. They clearly demonstrate that, as feared, public sector bodies have not been able to implement the new rules effectively which has led to the public sector failing to deliver projects effectively and independent professionals being locked out of the public sector.

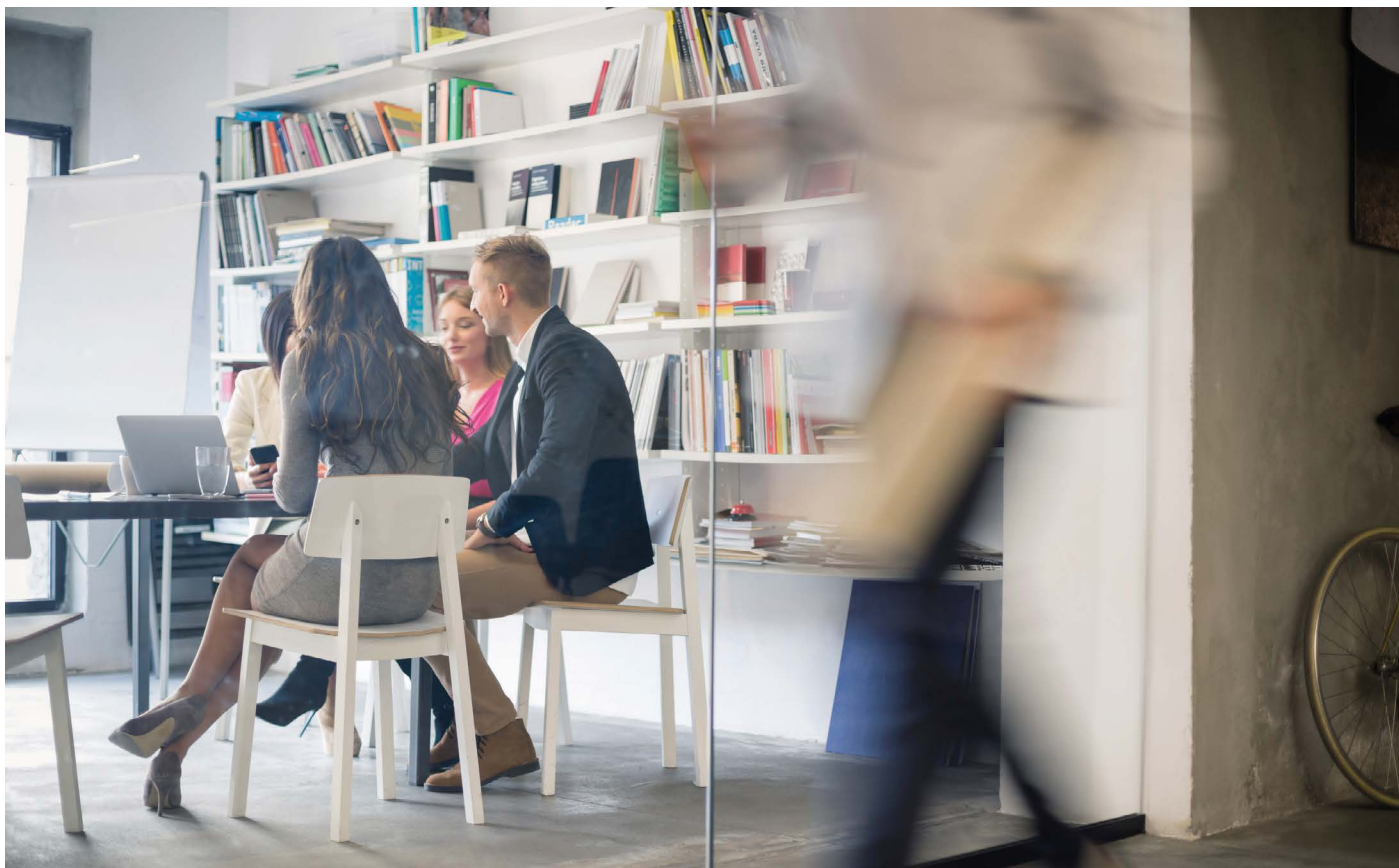
Government should not ignore the mistakes made in the implementation of this policy. A similar change in the private sector would have disastrous consequences for the self-employed, but more importantly for the flexibility and health of the UK economy.



The Economic Impact of Personal Service Companies

Report

August 2016



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.....4**
- 1. Introduction.....6**
- 2. The Prevalence of PSCs.....7**
- 3. Economic Impact.....8**
 - 3.1 The Economic Impact Framework.....8
 - 3.2 Total Earnings.....8
 - 3.3 Direct Contribution.....9
 - 3.4 Indirect and Induced Contributions.....10
 - 3.5 Impact on Different Industries.....10
 - 3.6 Productivity of PSCs.....12
- 4. Wider Economic Benefits.....13**
- 5. Conclusion.....13**
- 6. Appendix: Methodology.....14**



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.

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.

307,000

PSCs in the UK in 2015

This represents annual growth of 5.5 percent
since 2012/13

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 University¹ 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:

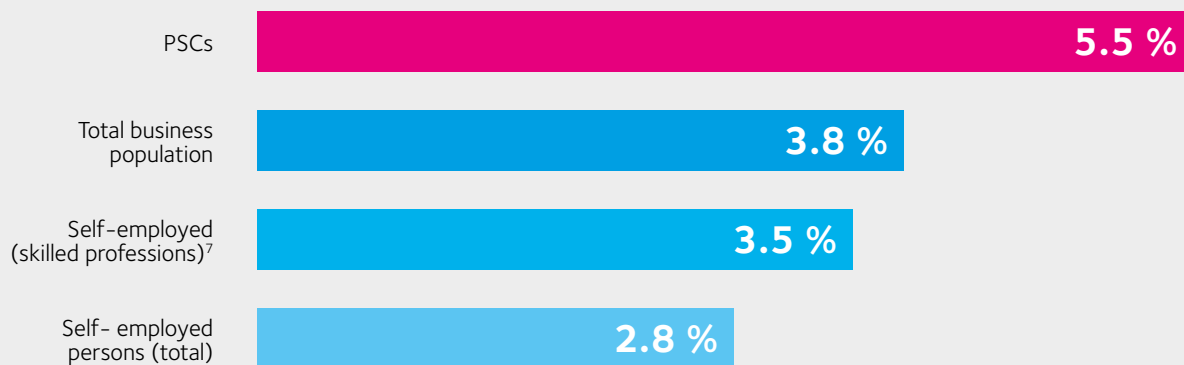
“It is understood generally to mean a limited company, the sole or main shareholder of which is also its director, who, instead of working directly for clients, or taking up employment with other businesses, operates through his company.”⁶

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.

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.

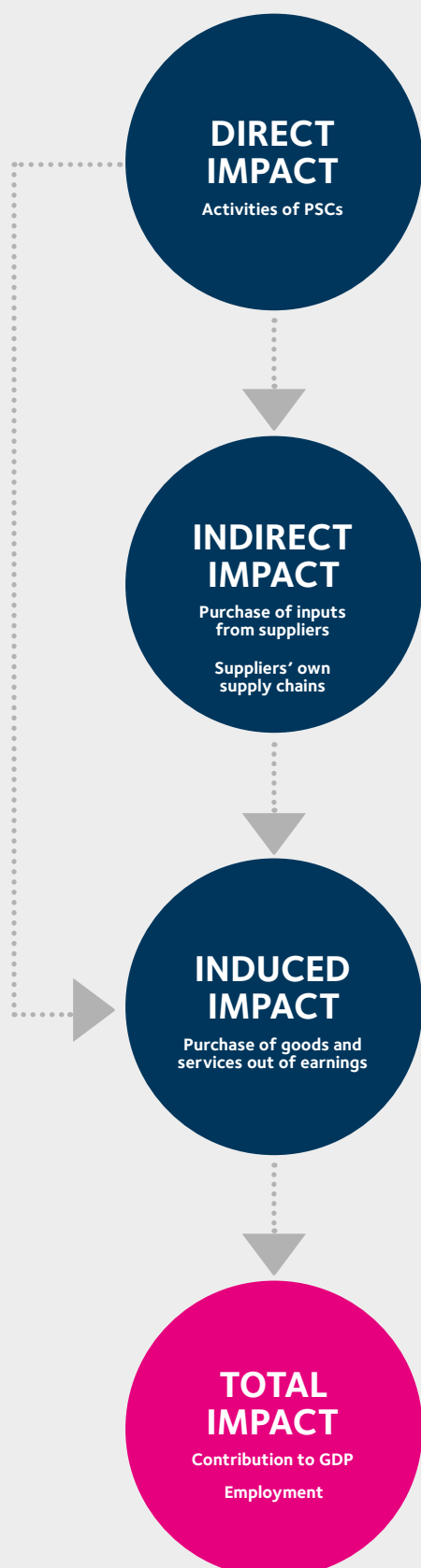
⁸ HM Revenue & Customs, "Intermediaries Legislation (IR35): discussion document" (Technical note, HM Revenue & Customs, 2015). As part of the study, attempts were made to source a more recent figure from HMRC. However, details about any more recent research and the methodology used in the original estimate 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

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

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

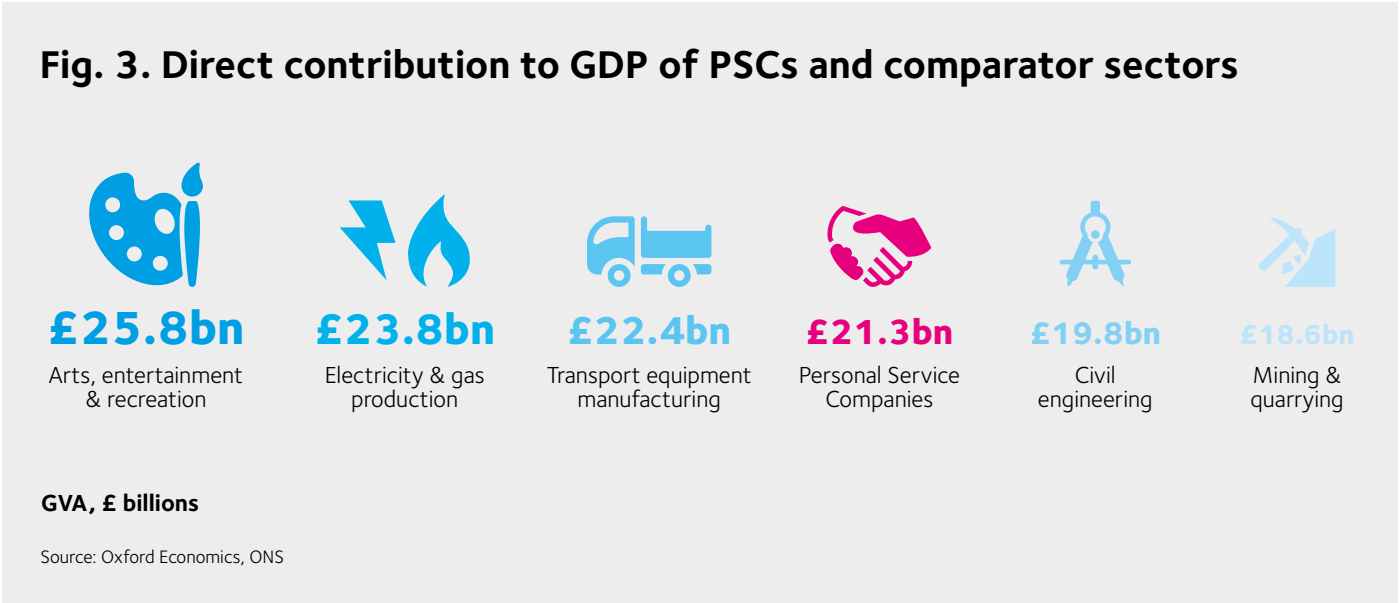
¹³ Analysis of ONS data on the GDP deflator shows that inflation has been around 12.8% with productivity having grown by 2.5%. Inflating the 2008 figure by this much leaves PSCs operating with turnover around 32% higher.



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.



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.

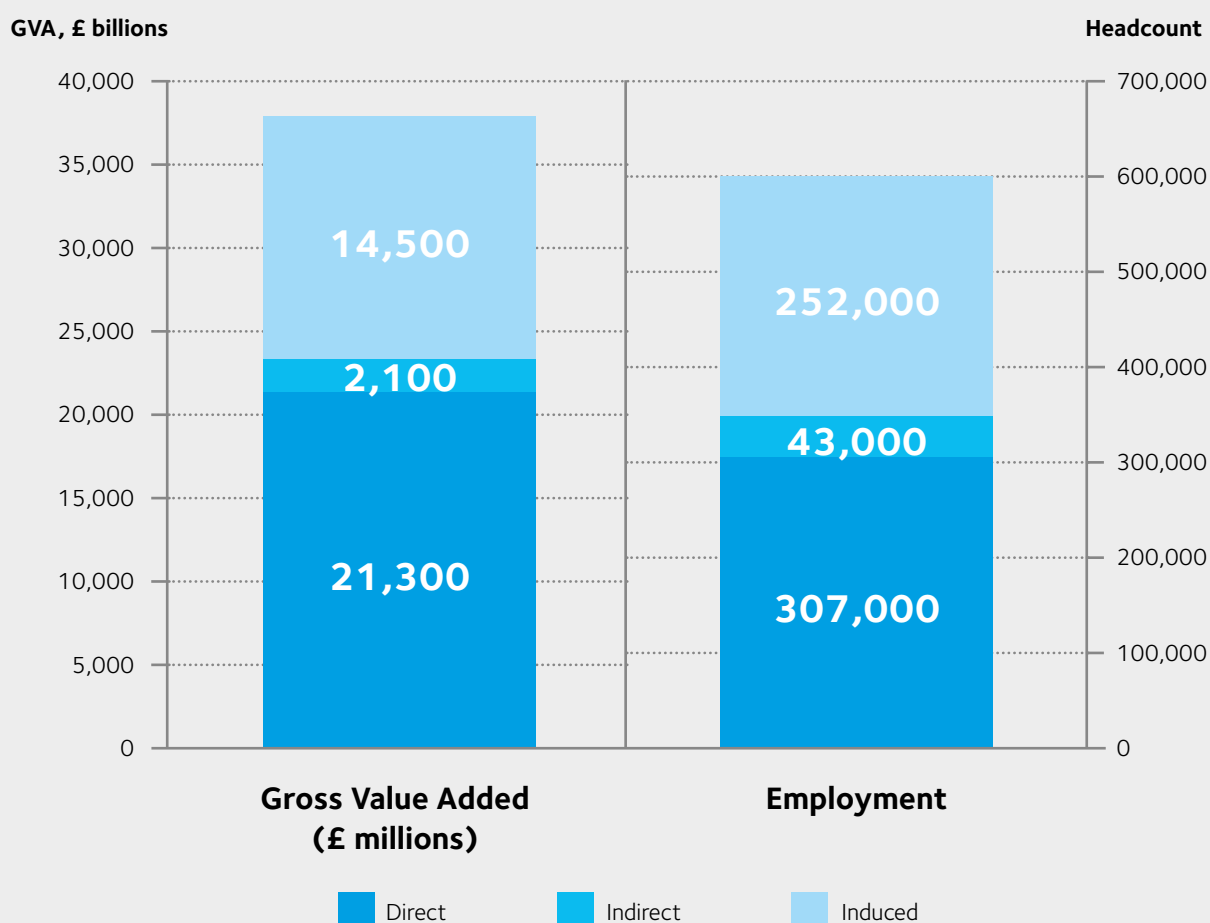
In contrast to this, a substantial £14.5 billion of GDP is supported through the induced effect as PSCs make purchases in the consumer economy from their significant income. The total contribution that PSCs made to UK GDP therefore stood at £37.9 billion in 2015.

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



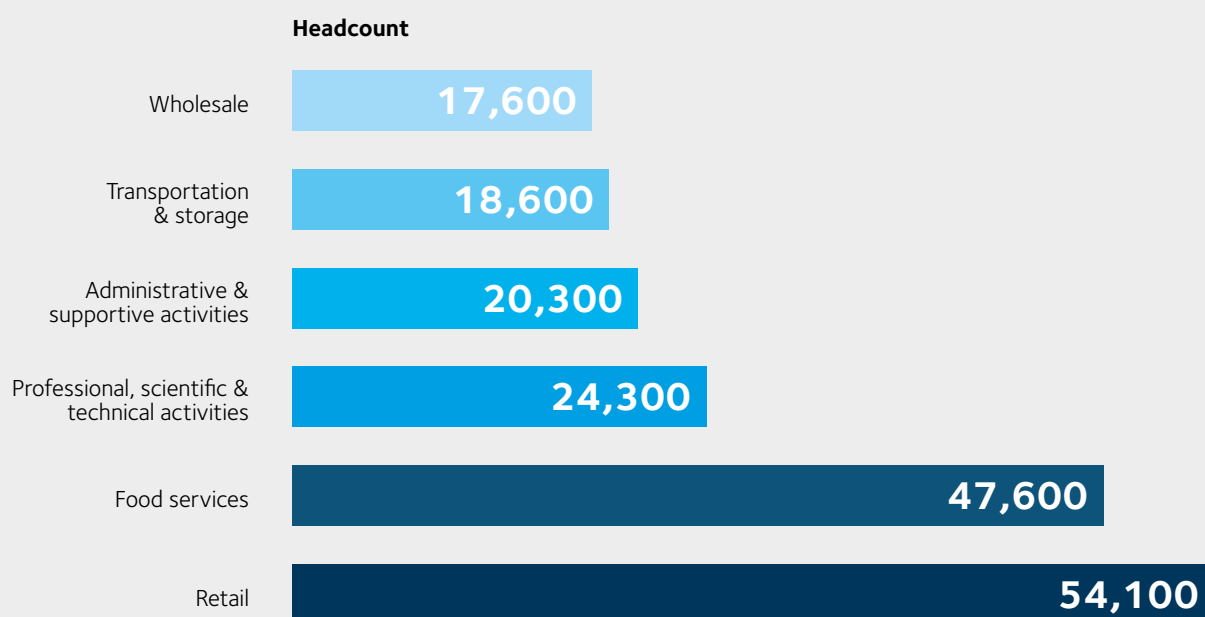
Source : Oxford Economics

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

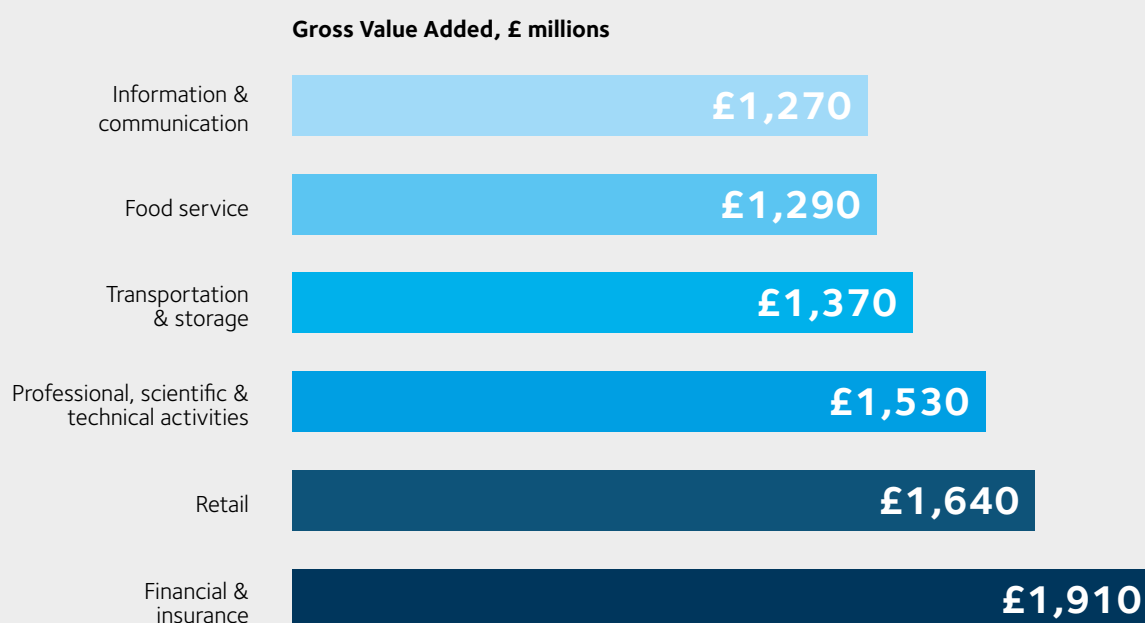


Source: Oxford Economics

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

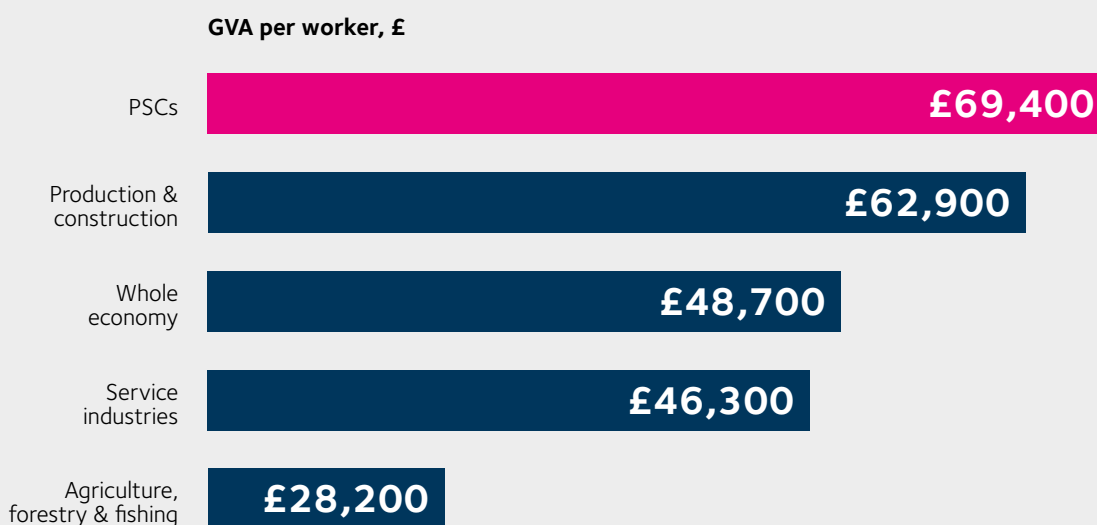


3.6 Productivity of PSCs

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 Committee on Personal Service Companies, “First Report” (Report, 2014), Ch. 2.

¹⁵ Vodafone, “Vodafone global 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.

Ms Rowena Fletcher
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27 March 2018

Dear Rowena

IR35 Forum – HM Revenue & Customs Position Paper on Mutuality of Obligation

Thank you for explaining HMRC's position on mutuality of obligation ("MOO") at the IR35 Forum meeting on 11 December 2017 and in your subsequent position paper, which I have carefully considered.

As you know, the discussion around MOO is particularly important in relation to the Check Employment Status for Tax ("CEST") tool which does not consider the existence of MOO in an engagement. Broadly speaking, this is because HMRC believe MOO always exists in any contract. We disagree, and this letter sets out our understanding of MOO and cites case law to support that view. In forming this view, I have drawn on my own experience as Director of Policy and External Affairs at IPSE, the experiences of our members, the expertise of my colleagues and I have also spoken with lawyers and other experts in this area.

In your position paper, you quite rightly state that consideration is a basic requirement of any contract. However, we query whether it is correct to assume that the basic consideration of pay for work is sufficient to create the requisite MOO which characterises an employment relationship. We would challenge the notion that MOO exists in every engagement where there is an obligation on the individual to provide work and for the client to pay for work performed.

Case law establishes that something more is required for an employment relationship. For example, in *Usetech Ltd v Young (H.M. Inspector of Taxes) (2004) 76 TC 811*, Parker J said at paragraph 60:

"I would accept that it is an over-simplification to say that the obligation of the putative employer to remunerate the worker for services actually performed in itself always provides the kind of mutuality which is a touchstone of an employment relationship. Mutuality of some kind exists in every situation where someone provides a personal service for payment, but that cannot by itself automatically mean that the relationship is a contract of employment: it could perfectly well be a contract for free lance [sic] services."

Indeed, there have been cases which involve contractors providing services where the absence of MOO has been fatal to a finding of employment within the context of the IR35 legislation. In each of these cases, there was a contract in place. For example, in *Marlen Ltd v The Commissioners for Her Majesty's Revenue and Customs* [2011] UKFTT 411 (TC), the First Tier Tax Tribunal found that the requisite MOO for an employment relationship did not exist in relation to an individual who supplied engineering, design and drafting services to a client through an intermediary. There were at least a couple of occasions where the individual contractor was sent home without pay when the computer servers broke down, whereas paid employees were not sent home. In addition, both parties had terminated contracts part way through (there was a series of contractual engagements). These factors were deemed inconsistent with there being the requisite MOO, even though there was still a contract (or series of contracts) in place.

Similarly, in *MBF Design Services Limited v The Commissioners for Her Majesty's Revenue and Customs* [2011] UKFTT 35 (TC), the First Tier Tax Tribunal found that there was insufficient MOO to establish employment for tax purposes in relation to a contractor providing design engineering services to a client through various intermediaries. Again, this was despite the fact that there was a contract in place.

In the *Usetech* case mentioned above, Parker J summarised this by saying that the requisite MOO does not exist where there is both no obligation on the client to provide work and no obligation to pay the worker for time in which work is not provided: see *Usetech Ltd* per Parker J at paragraph 64.

MOO therefore does not exist in circumstances where, for example, the client can send the contractor home without pay when there is insufficient work or an unexpected break in the project. This is to be contrasted with an employment relationship where the employer would be required to continue paying the employee in such circumstances. MOO also does not exist where the client can end an engagement early without any obligation to provide notice or compensation, as there is no obligation to continue working or continue paying until the specified work is complete, as was the case in both the *Marlen* and *MBF Design Services* cases referred to above.

As set out in your position paper, CEST does not explicitly look at MOO. However, in light of the above, it cannot be said that MOO is present in all public sector engagements or that every person using CEST will have already established MOO. Accordingly, the CEST tool overlooks a fundamental aspect of the test for employment status. This is particularly significant given HMRC's guidance that it will "stand by" the result of the CEST tool (unless the information provided is not accurate). In our experience, clients (particularly those in the public sector) place great weight on the results of the CEST tool. However, many of IPSE's members have reported that they disagree with the outcome of the CEST tool; it does not always provide a completely accurate assessment of an individual's employment status.

In *Hall v Lorimer* [1992] STC 599 at 611, Mummery J made the following observations about the test for determining whether someone is an employee or self-employed:

"In order to decide whether a person carries on business on his own account it is necessary to consider many different aspects of that person's work activity. This is not a mechanical exercise of running through items on a check list to see whether they are present in, or absent from, a given situation. The object of the exercise is to paint a picture from the accumulation of detail. The overall effect can only be appreciated by standing back from the detailed picture which has been painted, by viewing it from a distance and by making an informed, considered, qualitative appreciation of the whole. It is a matter of evaluation of the overall effect of the detail, which is not necessarily the same as the sum total of the individual details. Not all details are of equal weight or importance in any given situation. The details may also vary in importance from one situation to another."

Each individual's circumstances must therefore be assessed in the round. Without any questions related to MOO, the CEST tool does not give the complete picture.

Given employment status is so complex, we also feel it would be helpful if there were some avenue for contractors to challenge or appeal any conclusion of employment status that a public sector client makes under the off payroll working rules. Due to some public sector clients' excessively cautious assessment under the off-payroll rules and reliance on the CEST tool (which does not take MOO into account), many contractors are finding that their fees are being treated as deemed employment income when they remain legitimately self-employed. Such appeal or challenge could be either to the client itself or to some external body such as a tribunal, although the forum for any such challenge or appeal would need to be considered further.

In light of the above analysis, I would therefore urge HMRC to reconsider its position on MOO generally and in relation to the CEST tool.

Yours sincerely

Simon McVicker
Director of Policy and External Affairs, IPSE