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Dear Simon

The Freelancer Limited Company – the case for exploring this policy option

Further to my letter of 16 April 2015 and our subsequent discussions with you and a number of your members on 15 July, I am writing to set out the reasons for considering the development of a Freelancer Limited Company ("FLC") as a safe harbour for the majority of your members. In considering this, you have asked for my perspective as to the recent changes and what this might herald for freelancers.

My letter of 16 April set out the tax environment leading up to election including the exclusion of travel and subsistence from National Minimum Wage calculations, the restriction on salary sacrifice and overarching contracts[1]. That letter concluded that:

> *"[T]his sector has experienced a lot of change since the introduction of IR35 and there is a widespread belief that the current environment is suboptimal. The above analysis indicates that there are drivers which point to the potential for more change that could impact freelancers."*

That letter set out the drivers that existed prior to the election and this letter therefore does not seek to repeat those, but to build from them and the outcome of the July 2015 Budget to conclude on the attractiveness of developing the Freelancer Limited Company ("FLC") as a policy alternative.

Key messages to take from the July Budget

The July Budget clearly indicated that the Government is looking to reform taxation in this area. This was evidenced by:

- The creation of a new "dividend tax", despite the tax lock on income tax rates
- Proposals to restrict travel and subsistence relief for those operating within intermediaries
- The focus on HMRC's estimate that IR35 fails to collect £400m of tax revenues and the announcement of new consultation
- The publication of the latest figures on the scorecard effects on tax motivated incorporation

Each of these items is discussed below.

[1] HMRC "Employment Intermediaries: Temporary workers – relief for travel and subsistence expenses" published on 16 December 2014.

- Dividend taxation

  The new dividend tax, which has been presented as a 7.5 percentage point premium upon the existing income tax rates, represents a significant move to reduce the tax incentive for incorporation. The creation of a new £5,000 "allowance" will ensure that this impact of the tax is relatively targeted, affecting freelancers, owner-managers and those with share portfolios (held outside of ISAs or pensions) of over £140,000 (assuming a dividend rate of 3.5%).

  From a political perspective, this is a relatively contained community and the Government may be willing to weather any complaints.

  Considering the changes that were made, there appears to be little logic behind the rate of 7.5% and this has created some odd higher and additional rates. With the formal removal of the tax credit, there is less logic for any particular rate and therefore these rates should be considered as unanchored and open to change (i.e. increase) in the future.

- Proposals to restrict travel and subsistence relief for those operating within intermediaries

  Ahead of moves intended to stop tax motivated incorporation, the Government is looking to restrict relief for those contracting through intermediaries. HMRC published the '*Employment intermediaries and tax relief for travel and subsistence*' consultation which includes the proposal to restrict tax relief on work travel and subsistence expenses for those engaged through employment intermediaries. The restriction applies where any party has the right of supervision, direction or control over the manner in which the worker provides their services (whether this right is exercised or not). In addition the proposals include making the engager for whom the worker provides their personal services jointly and severally liable to HMRC for any outstanding obligations.

  These proposals show that the Government is looking to further restrict the tax efficiency of intermediaries and it is unlikely that business-focused reliefs will remain available to all those operating through intermediaries. The inability of the Government to distinguish between those in business on their own account and others is likely to result in restrictions on all intermediaries.

- The renewed focus on IR35

  In the Budget, the Government published its assessment of the shortfall in receipts from the operation of the IR35 regime.

  > *"The government recognises that many individuals choose to work through their own limited company. However, where people would have been employees if they were providing their services directly, anti-avoidance legislation commonly known as IR35 introduced in 2000 requires that they pay broadly the same tax and National Insurance as other employees. As highlighted by reports from the Office of Tax Simplification and the House of Lords, it is clear that IR35 is not effective enough. Non-compliance in this area is estimated to cost over £400 million a year."*

  Faced with this shortfall in revenues, the Government has argued that the IR35 system is in need of reform. We have since seen the publication of the consultation document, which has a primary option of shifting the burden of liability for tax and NICs onto the engager:

"those who engage a worker through a PSC would need to consider whether or not IR35 applies (in the same way they would need to consider whether a worker should be self-employed or actually be an employee), and if so deduct the correct amounts of income tax and NICs as if they would for direct employees."

Whilst your members may operate outside of the auspices of the IR35 regime, the practical risks facing engagers and indeed agencies may lead to a change in the contracting environment which could make engagers far less willing to take on risks of debt transfer, however small that risk might be.

- The publication of the latest figures on the scorecard effects on tax motivated behaviour

  The Office for Budget Responsibility report published at the Budget indicated the breadth of the Government's concern in relation to tax motivated incorporation. The table below shows that the Budget has reduced the incentive to incorporate in the short term but that this will rise above the level prior to the Budget by 2019, and will accelerate as the cuts in the corporation tax rate are delivered.

  A tax motivated incentive towards incorporation of £1.2bn by 2020 will continue to be a tempting target for the Treasury and I therefore believe that we will see more changes in this area. The timing may match the cuts in corporation tax rate, each of which significantly increases the level of profits before which it is preferable to be self-employed than operate as a fully distributing PSC.

Table A.5: Scorecard effects on tax-motivated incorporations

	£ million				
	Forecast				
	2016-17	2017-18	2018-19	2019-20	2020-21
Pre Measures TMI	-1055	-1235	-1400	-1515	-1660
Personal allowance: increase to £11,000 in 2016-17, with equal gains to higher rate taxpayers	0	0	0	0	0
Higher Rate Threshold: increase to £43,000 in 2016-17	0	-5	-5	-5	-5
Corporation Tax: reduce to 19% from 2017-18, and 18% from 2020-21	0	-35	-105	-125	-175
Employment Allowance: increase by £1,000 from 2016-17	0	-10	-10	-15	-15
Dividends tax: abolish credit, introduce new £5,000 allowance, and increase effective rates by 7.5pp	190	360	445	505	565
Employment Allowance: withdraw from single person companies	35	45	45	50	55
Post Measures TMI policy	-835	-880	-1030	-1100	-1235

Conclusions on the risk to the current status quo

Based on the above, it is clear that there is a strong likelihood of more changes in this area. Those changes can be expected to be revenue accretive to the Exchequer and could include harder tests for passing the successor to IR35, debt transfer to the engager and higher rates of dividend taxation. There appears to be little evidence that these changes would be frustrated or that the current regime would remain stable.

Role for the FLC

It is against this environment that I have therefore considered the role for an FLC. The FLC creates a safe environment for freelancers and seeks to identify them to HMRC as a ‘non-problem area’ where simplified administration, tax treatment and relief might be applied. Currently, HMRC has difficulty in quickly and effectively distinguishing between genuine freelancing and disguised employment.

The attractiveness of developing the FLC depends critically on:

- The approach that you believe HMRC will take to the wider sector (i.e. those not in an FLC) and
- Whether the Government will be attracted to delivering more generous rates for freelancers than for disguised employees.

Based on the above, it would appear that HMRC will look to increase the burden in this PSC sector. I would therefore suggest that there is a benefit to the FLC if you believe that a preferential regime can be delivered for freelancers. Given that the FLC will be an optional regime and therefore that freelancers would be unlikely to opt into a significantly more onerous regime than applies to the general Personal Service Company (“PSC”), the ongoing development of the FLC would appear attractive. Should the ultimate regime not prove to be attractive, then there would be limited take up and the downside would be contained.

In designing the FLC, care should be taken to maintain the optional nature of the FLC as this is a good defence against any risk that the regime could be imposed by government. In practice, I consider any attempt to force freelancers into an FLC unlikely to be attractive to government, which, as set out above, has already embarked on a wider reform. In contrast, the FLC represents a safe harbour which would be optional for your members to use.

Based on the above, and the increasingly burdensome PSC environment, I believe that the development of the FLC as a potential safe harbour represents a sensible policy approach in these uncertain times.

I trust that the above is helpful and look forward to discussing this with you further.

Yours sincerely

Chris Sanger

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