



TAXREP 60/13

(ICAEW REP 178/13)

ICAEW TAX REPRESENTATION

PERSONAL SERVICE COMPANIES

Comments submitted on 24 December 2013 by ICAEW Tax Faculty in response to House of Lords Call for Evidence in connection with its inquiry into the use of personal service companies and the consequences for tax collection published in November 2013

Contents

	Paragraph
Introduction	1-3
Who we are	4-6
Major points	7-12
Responses to consultation questions	13-51
 Facts and Figures for 2013	 Appendix 1
Ten Tenets for a Better Tax System	Appendix 2
How does IR35 measure up?	

INTRODUCTION

1. ICAEW welcomes the opportunity to provide evidence in connection with the [House of Lords inquiry into the use of personal service companies and the consequences for tax collection](#) published in November 2013.
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 2, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system, and have measured the personal service company legislation against them.

WHO WE ARE

4. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.
5. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

MAJOR POINTS

7. Personal service companies (PSCs) have an important role to play in the UK workforce. They offer the benefit of flexibility for both the engager and the worker which, where acceptable to both parties, is beneficial to the economy. Engagers value greatly the ability to source additional skilled manpower without adding to their staff numbers, and without adding to their potential obligations as employers. Since the managed service company legislation was introduced in 2007, it is very unusual for PSCs to be operated by, or for, workers without specialist skills.
8. PSC contracts can be terminated without the formalities and risks arising from the termination of an employment contract, so the engager is insulated from unfair dismissal and redundancy claims, claims under the Working Time Regulations and obligations under the pension auto-enrolment rules. The PSC is responsible for employer National Insurance costs and payroll operation as well as all the obligations just mentioned.
9. Not all PSCs are used to reduce the tax liabilities of the engager and/or the worker, but it is undoubtedly the case that provided the tax rules are complied with, such advantages can exist and can be considerable. Many PSCs have been created specifically because of the tax risks for the engagers in making an incorrect status decision. Many organisations need consultants for particular projects but worry that, if they agree to take on a self-employed worker, HMRC will recategorise the worker at a later date and assess the engager for the PAYE and NIC contributions alleged to be due. By that time it might be very difficult or impossible for the engager to recover any 'employee' liabilities from the worker in question. As a risk management measure, engagers therefore frequently insist that their workers work through a PSC. The worker may find a PSC attractive because of the ability to draw the income by way

of dividend, which is taxed more lightly than remuneration, but equally, some PSCs are no more or less than small businesses that have been incorporated to obtain limited liability.

10. The intermediaries legislation (IR35) applies to some contracts undertaken by some PSCs, but not all.
11. The IR35 legislation is very complex and relies heavily on employment status case law. As it must be considered for every contract undertaken by every individual working through a PSC, even though it is not relevant in most cases, it is burdensome. Indeed, some companies comply with the IR35 legislation when it does not in fact apply to them.
12. If the consequences of an adverse IR35 decision are placed solely on one party to a contract, it will often be impracticable or unfair. Without access to information about all aspects of the worker's business model and circumstances, the engager cannot make an informed decision; similarly the worker may not have the full information regarding the top contract making it impossible for the worker to make an informed decision. The current law places the burden on the worker, who also bears the cost of getting it wrong. This is unfair where the worker was forced to use a PSC by the engager or where they are taken on through a third party and do not know the details of the contract at the top of the engagement chain with the engager.

RESPONSES TO CONSULTATION QUESTIONS

Q1: To what extent are Personal Service Companies being used for the provision of personal services to UK businesses?

13. The term Personal Service Company (PSC) is not defined. It is understood to mean a company through which a worker provides his or her services to an engager, but the term can also be applied to companies owned by two or more workers supplying services, such as husband and wife companies.
14. While we do not have any statistical evidence, it is clear from discussions with our volunteers that PSCs are used extensively throughout the UK.
15. Since 2007, HMRC has included a question about the use of service companies on the self-assessment tax return and also, until last year, on the P35 year-end payroll tax return completed by employers. We do not know how this information has been used, but many tax professionals questioned whether HMRC had the necessary power to insist that this information was returned. Under the new Real Time Information system HMRC has the power to require employers to tell HMRC whether they are making their final return for the year as an intermediary or, for 2012/13 only, as a managed service company.

16. Companies House reports:

'Despite the recent challenging economic climate the number of companies incorporating with Companies House has continued to rise progressively since 2008, the biggest increase being seen in 2011/12 with over 455,000 incorporations.'

As the number of incorporations continues to grow and the number of businesses which do not employ anyone other than the owner also grows, there is every indication that PSCs are being used increasingly in the UK workforce, see Appendix 1. The number of PSCs falling within the intermediaries legislation will be a subset of the total.

Q2: What is your view of the effectiveness and efficiency of the intermediaries' legislation, first introduced in 2000, in facilitating tax collection?

17. The intermediaries legislation (IR35) exists as a deterrent to tax avoidance. Without this legislation a business could avoid taking workers who are in reality acting as employees onto

its payroll by engaging workers through the medium of the workers' own personal service companies. This would save employers' NIC and give the workers the opportunity to reduce their own tax and NIC by using dividend extraction. This is unlikely to be cost-effective for unskilled workers because of the running costs of the PSC.

18. IR35 does indeed act as a deterrent, but at some cost to the operation of the tax system.
19. The ICAEW Tax Faculty measures the tax system by reference to Ten Tenets, which were endorsed by the Treasury Select Committee report, Principles of Tax Policy, in 2011. We have measured IR35 against these tenets and it fails 7/10 tests. See Appendix 2. In our opinion, this makes it poor legislation.
20. Where the relationship between the engager and the worker clearly exhibits the hallmarks of employment, the legislation is effective. Establishing this clarity is however very difficult. There are considerable tax advantages to be gained by not being within the scope of the legislation, so there are incentives, for all parties to the contract for work, to ensure that it is not caught. This has spawned an entire industry which exists to help workers and their engagers avoid being caught by the legislation, leading to copious anti-avoidance legislation.
21. The effectiveness of the legislation is hampered by placing the burden for making the decision about whether or not it applies on the worker, who is often less well-equipped to understand its application and to access advice than the engager. The worker will also bear the financial consequences of reaching the wrong conclusion about the status of the contract.
22. That employment law and tax law do not follow the same rules makes it even more difficult for the parties to be clear about the worker's status. As HMRC chases new avoidance techniques using ever more complex legislation, the tax and employment law definitions move further apart, making the intermediaries legislation less efficient.
23. The responsibility for making the right decision about IR35 rests with the worker. Consequently, HMRC has many more targets for its enquiry work than it would have if responsibility lay with the engager, which must be less efficient for HMRC. However, moving the onus onto the engager would simply recreate the problem that the engager tries to address by insisting on the use of PSCs; the risk of getting a status decision wrong would rest again on the engager. It would not solve the bigger problem that lies at the root of that risk, ie, HMRC seeking to recategorise as many workers as possible as falling under PAYE and Class 1 NIC rules so as to collect more revenue. Whether the onus is on engager or worker to justify the status decision, the decision is equally difficult and time-consuming for all parties.
24. It is difficult to see whether or not the legislation is effective while HMRC undertakes so few enquiries, but as a deterrent, it must be effective to an extent. It is equally difficult to estimate how many PSCs that should report under IR35 rules fail to do so and are not identified or challenged by HMRC.

Q3: Should the current intermediaries' legislation be reformed and if so, what would be the alternatives?

25. In our view, the policy rationale behind IR35 is indeed justified, but the mechanics and ability of the rules as currently formulated to achieve their goals do need to be reviewed. We note that the Office of Tax Simplification has already undertaken its review, but feel that the emphasis on improved administration does not do enough to solve the problem.
26. The current legislation is overly complex and relies on considerable subjective guidance from HMRC and professionals for its interpretation. It appears to be honoured in the breach rather than the observance.

27. When a measure works quite as ineffectively as IR35 appears to, it undermines the policy itself, not only by failing to enforce it, but also by bringing it into disrepute.
28. Reform is required to make it more objective, to remove the uncertainty and in this respect the engagers should, arguably, be the first port of call if they incorrectly define 'their' relationship. Any intermediate company or agency screen should be ignored.
29. A possible area for examination is the discrepancy between tax and NIC rates between remuneration and dividends, which currently provides a clear incentive to incorporate and take dividends, albeit at the potential expense of future state benefit entitlement (which many PSC owners regard as nugatory anyway). Addressing this difference might lead to a solution to the tax-driven incorporations, but we should not disregard the non-tax drivers, such as avoiding the creation of employment rights, which are often equally important to the engagers.

Q4: To what extent does the current IR35 legislation impose additional compliance burdens and administrative costs?

30. The need to review every contract, by every individual worker, must be less efficient than considering the contract from an engager's perspective where many similar such contracts are being used. We note however, that it would be difficult for the engager in every case to know enough about the circumstances of the worker to unilaterally determine the employment status. The IR35 rules do not apply if the worker is effectively in business on his own account, even if for a short period he might undertake a full-time contract with one particular client. It is well-established that a worker who looks for the duration of a contract very much like an employee might not be so when that contract is put into the context of all his activity; that 'job' might easily be just one incident in a professional career, but it is impossible for the engager to know that without extensive enquiry.
31. While HMRC guidance and the free contract review service are helpful, more could be done to publicise this, although this may lead to more demand than it could cope with and it will probably need further resource if uptake improves. However, having had the contract reviewed and approved the compliance burden continues as it is important to ensure that the contract and the reality are the same.

Q5: Are the current avenues of consultation on IR35 working and what more should be done to ensure that the Government listens to interested stakeholders?

32. The IR35 Forum has worked well in developing new guidance, published in 2012. Not all parties to the forum agree with aspects of the Business Entity Tests and the point allocations in the scenarios. There is a risk that trying to make the tests more objective leads to nonsensical decisions, because different factors ought to carry different weight in different circumstances. We are concerned that these tests have been used by some businesses beyond being mere guidance to risk levels, as had been intended.
33. The Forum does not have policy making power and so has to work within the boundary of poor legislation.

Q6: Are HMRC's recent efforts in improving the administration of IR35 judgement cases working? Is more guidance and advice needed to aid individuals in judging the status of business transactions for themselves or should further resources be given to HMRC for compliance efforts?

34. Our members have reported very little indication from their clients that the number of IR35 enquiry cases being opened by HMRC has increased. It does however continue to be a topic of considerable concern as the consequences of making a mistake can be costly for the worker.

35. As the legislation is very unwieldy further guidance for non-tax specialists who use PSCs would be welcome.

36. As noted at 31 above the free contract review service should be more widely publicised.

Q7: Do businesses insist on the use of Personal Service Companies? If so, should responsibility be placed on them rather than the worker to decide whether a business transaction falls within IR35?

37. Some, large businesses in particular, require a worker to supply their services through a PSC. This can be to limit employee numbers, perhaps because a business has a limit on its headcount and so cannot add to the number of staff on the payroll. It is often to limit exposure to employment protection risks, such as the costs of unfair dismissal and redundancy claims, or statutory notice requirements and holiday pay entitlements. It can also be to save employers' NIC.

38. Where businesses insist on a PSC then the business should arguably take the responsibility for ensuring compliance with IR35 and for arranging for the contract review. Consideration should be given to making the business responsible for any additional tax and NIC if the arrangement is not compliant, although there would have to be some duty on the PSC worker to cooperate in arriving at any decision.

Q8: Are individuals forced into the use of a Personal Service Company as a prerequisite for being considered for work? If so, what can be done to ensure that the use of a Personal Service Company is appropriate for the individual?

39. We have anecdotal evidence that individuals are being forced into the use of PSC; this removes the need for an employer/employee contract which could give the employee rights and so impose additional financial burdens on the employer such as NIC and also redundancy payments when the employee is no longer needed. The individual may not obtain 'gainful employment' with that engager without using a PSC.

40. While there are senior workers in both the private and public sectors who choose to conduct their business through corporate structures, there are many more, less well paid individuals, who do not have this choice and are compelled to operate through a PSC or an umbrella.

41. One view is that the economic situation has possibly pushed businesses to offer work either via a PSC or umbrella employment businesses or on zero-hours contracts, just to give them the flexibility to pay for workers only when they are needed and not pay for downtime.

Q9: To what extent are Personal Service Companies still used in the Public Sector? Should those engaged in public bodies and similar organisations be prevented from working through a Personal Service Company? If so, would the Public Sector experience difficulties in obtaining the skills and expertise that are needed?

42. We have no evidence regarding the incidence of PSC use in the public sector. However, we can see no reason why the public and private sectors should be treated differently, nor why the public sector should be denied the right to use freelance workers as they see fit. Hiring and firing processes in the public sector can be cumbersome, and the ability to use workers billing for their services through PSCs is a clear aid to efficiency.

Q10: What role do Umbrella companies play? To what extent are agencies encouraging individuals to enter into such structures?

43. Some engagers require a worker to sell their services through a limited company. To avoid having to set up their own company, and then having to operate a payroll, a worker may instead work under an umbrella company. The umbrella invoices the engager for however many hours the worker charges in the month, processes however much the worker earns from this, and pays the rest to the worker under PAYE.

44. Umbrella companies effectively allow a worker to outsource their own payroll, but the effect is that the worker has to bear the employer's NIC on whatever the engager pays under the contract.
45. All the umbrella does is to employ the worker on a permanent contract of employment, hold the contract with the engager and process the individual's pay. The worker may be working with lots of agencies and engagers, all of which can be invoiced on their behalf by the umbrella. There will often be lots of other workers working under the same umbrella company, but they too will all have PAYE and NIC deducted. There is therefore no tax saving to the employee unless other factors apply, such as the possibility of obtaining a tax deduction for travel expenses if work is being done at temporary workplaces.
46. The dividend method of paying workers is not used by umbrellas, as they typically do not hold shares.

Q11: Aside from the issues of Tax and National Insurance, what are the wider benefits and drawbacks for the individual of using a Personal Service Company?

47. Using a PSC can give an individual flexibility as to when to work, as they do not fall under the control of the engager in the way an employee does.
48. Limited liability protection is afforded by the PSC should a claim be made against them and this is particularly attractive to workers in certain fields, such as IT, where the value of potential claims is well in excess of the remuneration received.
49. The worker who is in effect a one-man business can build a name and a mini-brand to help to attract new business by always working through the same company. A good name can be important and can be protected by incorporating a company by that name. The PSC can also make it look to the world at large as if the business is more substantial than a jobbing one-man consultancy.
50. The main worker is free to engage his own help unless there are particular requirements (such as security clearance) involved.
51. The freelance worker is often one who dislikes the constraints of large organisations and likes the freedom to pick and choose which contracts to take and when to leave. The larger organisations often like the freshness of thought brought by freelancers who have worked elsewhere recently and appreciate the new skills they bring without the engager having to fund the update training or take them on with a bundle of employment rights.

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APPENDIX 1

FACTS AND FIGURES FOR 2013

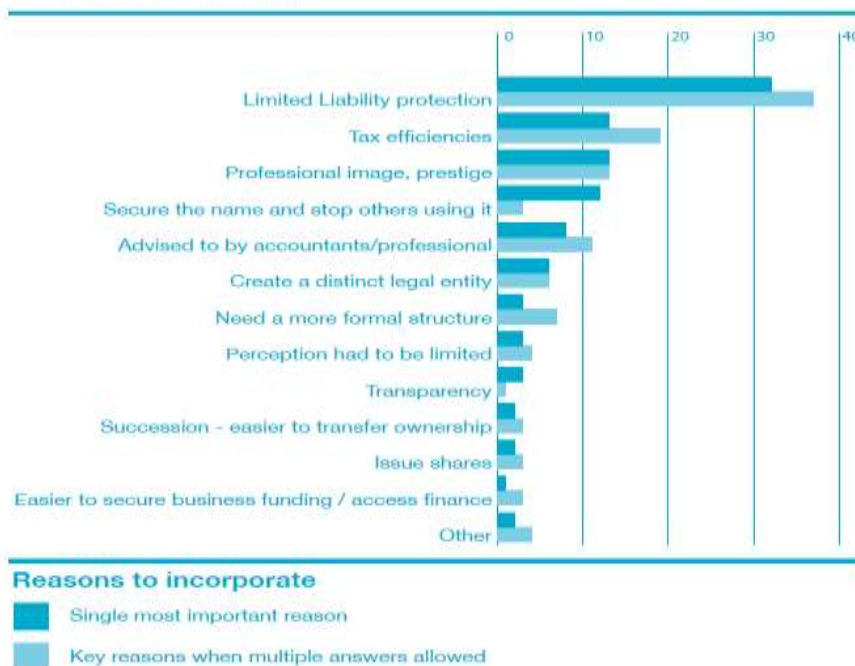
1. There were an estimated 4.9 million private sector businesses in the UK at the start of 2013, an increase of 102,000 compared to the start of 2012. Of these, around 1.6m are employers, and of those around 1.2m have four or fewer employees.
2. As in previous years, the latest rise has been driven by the growth in the numbers of smaller, non-employing businesses – there were 127,000 more of these than at the start of 2012.
3. The majority (62.6%) of private sector businesses were sole proprietorships, 28.5% were companies and 8.9% were ordinary partnerships.
4. 75.3% of private sector businesses do not employ anyone beside the business owners.
5. At the start of 2013, 62.6% of private sector businesses were sole proprietorships, 28.5% were companies and 8.9% were ordinary partnerships.
6. There were an estimated 3.1 million sole proprietorships in the UK at the start of 2013, of which 231,000 (9.0%) had employees.
7. There were 1.4 million companies, of which 789,000 (56.5%) had employees.

Source: Business population estimates for the UK and regions 2013. Department for Business Innovation and Skills, October 2013

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/254552/13-92-business-population-estimates-2013-stats-release-4.pdf

Companies House recently conducted research into why 400 businesses selected at random had chosen to incorporate with the following results:

Allowing for multiple answers, respondents still cited the protection of Limited Liability as the predominant reason behind their incorporation, with; tax efficiencies; being advised by an accountant or professional to incorporate; and the need to have a more formal structure, as being the second most prominent reasons for incorporating.



<http://www.companieshouse.gov.uk/about/pdf/incorporationResearchResults.pdf>

APPENDIX 2 ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

How does IR35 measure up?

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament. **FAIL**. Business must rely on extensive guidance from HMRC. There is evidence that the recent Business Entity Tests are being used to give absolute answers on contract status as opposed to being merely indicators of risk.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs. **FAIL**. Complex rules relying heavily on case law and subjective judgement does not lead to certainty.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives. **FAIL**. The onus for determining whether the legislation applies is on the worker. Many of these are ill-equipped to interpret the law and do not have access to tax advice. Many are unaware of the help on offer from HMRC.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect. **FAIL**. The calculations are not simple. Every individual contract undertaken by every worker potentially affected needs to be reviewed.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes. **FAIL**. Anti-avoidance legislation has been needed almost every year since 2007.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear. **PASS**. The basic legislation has remained unchanged.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it. **PARTIAL PASS**. Consultation has been undertaken as far as time was allowed. Unfortunately, the underlying problems remain and successive changes have merely applied sticking plasters. The fundamental flaws remain.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed. **PASS**. Although problems remain.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions. **FAIL**. It cannot be fair and reasonable that workers are engaged but denied rights commensurate with employee status. Conversely, there are other workers who for sound commercial reasons need to be self-employed, either with or without a corporate structure. The IR35 rules make this unnecessarily complex.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK. **FAIL**. When a measure works quite as ineffectively as the IR35 legislation, it undermines the policy itself, not only by failing to enforce it, but also by giving it a bad name.

The ten tenets are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)