TAXREP 51/15 (ICAEW REPRESENTATION 139/15)

INTERMEDIARIES LEGISLATION (IR35)

ICAEW welcomes the opportunity to comment on the discussion document *Intermediaries Legislation (IR35)* published by HM Revenue & Customs on 17 July 2015.

This response of 2 October 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 6 August 2015 we attended a meeting with HM Treasury and HMRC jointly with other professional bodies in which we were able to put forward some key comments and discuss aspects of the discussion document.

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MAJOR POINTS

1. We make four broad recommendations:

(a) The policy team should consult the papers from 1999 when the intermediaries rules for personal service companies (PSCs) were first conceived and planned, to remind themselves of why the current proposals were rejected then as unworkable.

The introduction of RTI reporting has increased the practical problems that were foreseen then, when timescales were longer. It is impossible for an engager to calculate the correct (or even a fair) amount of PAYE and NIC on payments made to an intermediary: how would 'earnings' be calculated so as to exclude agents' profit margins, which PAYE code would apply, how would engagers know that they were dealing with a PSC, and which earnings periods and limits would apply for NIC? The proposals are impracticable, even if the engager has enough knowledge of the contractor's circumstances to be certain that the worker is employed by a PSC, which may not always be the case, especially where workers are supplied up a chain of intermediaries.

(b) We recommend that no more changes should be made to the law in this area, including the IR35 legislation, pending the bedding in of changes already made and in prospect.

The main problem with tax-motivated incorporation (TMI) is in the volume market for low earners, but the introduction of the dividend tax in 2016, and the restriction of travel & subsistence relief for workers engaged via intermediaries planned for the same date, should make the PSC markedly less attractive because the costs of setting up and running a company should not be matched by tax and NIC savings. A future adjustment to the dividend tax rate could increase the deterrent effect.

(c) HMRC should properly police the existing legislation and improve guidance, with a special version of the Employment Status Indicator tailored to IR35 to help PSCs and their advisors make the right choices and reduce the workload for HMRC by providing an IT filter that is robust and binds HMRC when it indicates that IR35 should not apply.

We would expect the current proposals simply to change the focus of any disputes rather than make them fewer in number and easier to resolve, so HMRC's only advantage arising from the proposals would be in having more confidence that the liable party would still be in existence if HMRC's view on liability prevailed in due course, which would not be a gain large enough to counterbalance the pain for many engagers if the current proposal goes ahead.

(d) Rather than trying to patch up IR35 with added complexity, the Government should consider a long-term, more fundamental reform with a view to removing the differential liabilities that drive TMI.

With this in mind we strongly endorse the recommendation of the Office of Tax Simplification in its report on employment status last March, that there should be a joint review between HMRC, HM Treasury, the Department for Work and Pensions and the Department for Business, Innovation and Skills to look at the possibility of developing an agreed code of principles for employment status. This would presumably include IR35. The OTS project on closer alignment of PAYE and NIC may also produce proposals that reduce the problematic differentials. These are major projects rather than another sticking plaster on a broken and misconceived approach that has caused business, advisers, IR, DSS and HMRC problems since it was introduced. Many otherwise self-employed workers operate through a limited company because engagers insist on it (in order to avoid employment protection costs) and to reduce their exposure to negligence claims, so they will not disincorporate, but the tax- and NIC-based incentive to incorporate other operations could be removed much more effectively by getting to the root cause. Since

NIC rules are about to be reformed for Classes 2 and 4, and the OTS is consulting on the future of the employer contribution, we would also very strongly recommend awaiting the outcome of that review before attempting further running repairs to IR35. Extending the remit of the OTS to encompass the IR35 problem would also be a possibility. By contrast, the recent practice of patching up loopholes in the law has generally just created or exacerbated different problems, which then need patching up in turn. This approach can be likened to pushing down a cork in a jar of water – it merely pops up somewhere else. Very few of these patches have really worked satisfactorily: in our view the only one that has been really successful since the introduction of IR35 has been the managed service company legislation which came in in 2007.

2. In the long run we do accept that the status quo is unsustainable, but however strong the case in principle for passing the compliance burden on to the engager in some way, we do not regard the proposals as practicable. This is not only because of the compliance problems, but also the difference it is likely to make to yield, once all factors are taken into account. Once the dividend tax is introduced next year HMRC's take from IR35 – when one takes into account what they would in any case receive by other means such as corporation tax if IR35 did not apply – will consist largely of the equivalent value of employer's national insurance contributions (NIC).

3. However there are serious practical problems in moving liability for employer NIC onto the engager, where it arguably should fall if the engager is acting as a quasi-employer, and if these are not looked at very carefully there is a risk of making matters even worse than they are now. Some members have expressed the view that engagers should be required to pay the employer's NIC in respect of payments made to PSC workers, but cannot see a practicable way of identifying the correct circumstances for triggering liability, protecting PSCs from over-anxious clients who deduct at source just to be on the safe side (which would be one inevitable outcome, launching a new wave of non-IR35 refund claims with which HMRC would have to deal), or calculating any such liability on an accurate or equitable basis.

COMMENTS

4. As noted in HMRC's discussion document, the legislation introduced in 2000 to tackle the avoidance of employment taxes by those who work through intermediaries is not working as effectively as it should be and there is non-compliance. Government is seeking suggestions as to how to improve compliance and protect the exchequer.

5. We accept that there is under-compliance, but this is principally because there is no hope of proper compliance without more policing by HMRC, and as a large number of micro-companies is involved, HMRC cannot police IR35 properly without vastly more resources. The question arises as to the likely return from that cost.

6. We believe that the IR35 legislation must be looked at in the context of other legislation which impacts this area. The report of the Office of Tax Simplification (OTS) of last March contained 63 references to IR35 even though the subject was specifically outside its terms of reference. This demonstrates that one cannot look at IR35 in isolation from other employment status problems.

7. It also should be borne in mind that IR35 is substantially a mechanism for collecting NIC and PAYE on profits paid out as dividends. Once the new dividend tax comes in next April, the owners of personal service companies of all kinds, whether or not falling within IR35, will pay substantially more.

8. We understand the case for shifting the burden on to the engagers of disguised employees in some way, since they should logically bear the employer NIC cost, rather than passing it on to the PSC (effectively transferring the employer liability to the disguised employee). It is also clearly much easier for HMRC to enforce a confirmed liability against an engager who is much

less likely to have disappeared by the time a dispute arises. However, we do not believe that the proposed approach will work in practice, and HMRC will simply be faced with a different set of problems.

9. As concerns the employer's contribution, the real objection to transferring this on to the engager is that engagers will have difficulty applying the tests. However if they have difficulty, the contractors who are supposed to be doing this at the moment are even less well placed to do it. So are their advisers. Some large engagers ought to be able to obtain the high quality advice that is needed here, but many will not. One likely result is over-compliance, which might not concern HMRC but ought to concern ministers, as this may have implications for fairness (as between businesses, between workers, and between both of those and the state) and the flexibility of the labour force.

10. Making the engager responsible for the disguised employee's tax and NIC has some very serious practical problems. One way that this might be done is by making the engager liable if the PSC fails to pay, which will not lead to higher levels of compliance as engagers will not have the resources or technical expertise to police this (if HMRC cannot do it then how can they?) and PSCs will behave just as they are doing now.

11. The alternative would be to make the engagers operate PAYE RTI. The system is under severe pressure as it is, dealing only with direct employees, and many of the problems with it surround joiners and leavers. By the nature of PSC contracting, this will become a far worse problem because IR35 people join and leave engagements very frequently – for example a supply teacher may go to five different schools in a week. The issuance of P45s and their subsequent input into the new employer's systems will never keep up with this, and what one will end up with is people on emergency codes for most of their work and a massive reconciliation exercise needing to be undertaken by HMRC at the end of each year, for which it will need substantially more resources than it has at present and for which it will undoubtedly face loud criticism in the press. We view this prospect as positively alarming, as should ministers and HMRC.

12. There is also the problem of how to deal with the margin. All that the engager knows is what it pays the agency, which will typically take a margin of about 14% – it will not be seen as fair if the contractor has to pay tax on this as well, but how does the engager otherwise find out? It may equally be the case that there is more than one intermediary in the chain. Again, how does the engager know?

13. Likewise there is the problem of how to define the PSCs for whom the engagers will have to operate RTI, which lies at the heart of all IR35 disputes. If it were possible to come up with a satisfactory definition this would have been done by now, as it has clearly been wanted for some time. Engagers will have particular difficulty in knowing whether there is a PSC involved in cases where an agency is involved, as all they will know is that they are paying an agency.

14. In addition, any definition will be open to gaming. The consultation assumes that the engager will know whether the worker supplied by the PSC is under supervision, direction or control, but in large organisations this is far from true: the PSC invoice will usually be submitted to some central point, far removed from the 'coal face' where operational staff will know how work is done. Given the manifest difficulties over many years in reaching agreement between HMRC and engagers over whether IR35 might apply in cases investigated by Employer Compliance staff, it is not clear how HMRC can believe that operational staff might be in a position to make that call.

15. We would also mention that there are two premises that we cannot accept, both of them on page 4 in the discussion document.

16. The first is that IR35 is designed to ensure that deemed employees pay similar amounts of tax and NIC as actual employees. It does no such thing, as it makes the deemed employees pay the employer's NIC share, which an actual employee does not have to do. The deemed employees under IR35 thus end up paying substantially more than actual ones.

17. The other is HMRC's estimate that only 10% of the companies ought to operate IR35 actually do so. We believe HMRC should publish the basis and explanation of this estimate – given that HMRC loses as many IR35 arguments as it wins, we question whether half of the other 90% are in fact non-compliant. If someone is in a deemed employment relationship he will not want to set up his own company because it is too expensive and too much trouble – he will join an umbrella company. So whilst we accept that there is some non-compliance, we doubt that it is as serious as 90% non-compliance.

18. In recent years the Government has introduced a large amount of legislative changes, some of which came into force only on 6 April this year, some will commence next year, and other changes are in the pipeline which are being consulted on. It will take time for the effect of all these changes to become apparent. We therefore believe that no more changes should be made to the legislation in this area, including the IR35 legislation, pending the bedding in of the changes already made and in prospect. We believe that the introduction of the dividend tax will play a significant role in dissuading bulk users of PSCs from incorporating, and that the workers are more likely in future to move to an agency job or an umbrella employment.

19. We also consider that more effective policing by HMRC of the current legislation would improve compliance – and government should ensure that HMRC has the necessary fully-trained technical and investigation resource to undertake the work proportionately and fairly.

20. The changes that need to bed in are:

- **(a)** the adjustments to s.44 ITEPA 2003 under which supervision, direction and control (SDC) are the criteria (which may encourage intermediaries to supply workers via umbrella companies (UC) rather than personal service companies (PSC)),
- **(b)** the intermediaries reporting requirements introduced from 6 April 2015 (the information from which will enable HRMC better to police compliance),
- **(c)** the dividend tax (the rate of which will not be subject to the tax rate lock and which may lead to a reduction in the number of PSCs),
- **(d)** the forthcoming amalgamation of Classes 2 & 4 NIC for the self-employed (the combined rate of which could be set at a figure which eliminates the employed/self-employed differential and, indeed, could be almost the same as the Class 1 primary rate given that the only additional contributory benefit that Class 1 NIC now buys when compared to Class 2 is jobseekers allowance, which is relatively insignificant),
- **(e)** changes arising from the review by the Office of Tax Simplification of tax and NIC alignment, and
- **(f)** changes proposed to the travel & subsistence rules for intermediary workers, which will apply to PSC workers (whether or not in IR35 companies) and umbrella company workers.

21. The changes in prospect will require sensible lead-in times to enable HMRC to draft the necessary IT specifications early enough for robust software (commercial and HMRC's) to be designed, built, tested (to ensure not only that it works but is compatible with existing IT) and installed, and for users to be trained before go-live.

22. Other suggested solutions have been mooted to resolve the problem but we do not favour these over our recommended approach as they create additional problems. These other suggestions include the engager accounting for an offsettable flat-rate deduction at source where there is SDC or the worker is in IR35, or engagers paying employer NIC where there is SDC or the worker is in IR35. We consider that these would not be effective because they

would suffer from the same disadvantages as requiring the engager to account under PAYE for payments where the worker is within IR35 or there is SDC, namely that the engager is unlikely easily to be able to find out the amounts on which to calculate the charge, and HMRC if they wanted to check compliance would have to make inquiries of several parties, in respect of every separate contract, to ascertain whether there was in fact SDC or IR35, which would be very time consuming and arguably yield as little in relation to effort as IR35 compliance work now.

23. As concerns the document's request for comments on whether a switch should be made to the same status test as is used with agencies (supervision, direction or control as to how the work is done), we can see some merit in this if and insofar as the responsibility for operating the system (NB not the ultimate compliance responsibility) is switched to the engager, but not otherwise. We do however have serious reservations about the position of those one-man companies whose trade generally involves no supervision but who occasionally take on a short contract that might be treated as disguised employment if the engagement was for a longer period. It has been acknowledged for a very long time that self-employed workers (and here we include those operating through a limited company for liability or practical reasons) should be able to take on short contracts resembling employment without destroying their self-employed status and without having to switch between two tax systems: we would specifically draw attention to the case of *Davies v Braithwaite*, which showed that intermittent engagements similar to employment may be treated as mere incidents in a professional career. It would be wrong to impose a new system with added liabilities and compliance burden on those who are not abusing the current one. We suggest therefore that this option be kept open with a view to deciding when HMRC's preferred course of action is closer to being decided on, and after the dividend tax and travel & subsistence changes have bedded in and their effects on the perceived abuse of IR35 have been measured.

APPENDIX 1

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

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

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.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

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.

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.

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.

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.

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.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).