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Personal service companies - "the wrong kind of enterprise"

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***B.T.R. 1** IR 35¹ may be the most famous Inland Revenue Press release ever published. The opponents of the new personal service intermediaries legislation have adopted this title as a useful shorthand for the object of their anger and the Inland Revenue has begun to use the shorthand itself. The legislation has had a high media profile. There are numerous articles and at least one book² about the detailed operation of the legislation and the Inland Revenue has responded to pressure by opening up a special section of its website to deal with the issue, replete with a list of frequently asked questions and their answers.³ The Professional Contractors' Group, created to oppose the legislation, also has both a thriving website⁴ and membership. It has sought and gained leave to proceed with a judicial review application to be heard in March 2001.⁵

The legislation as finally enacted⁶ applies to engagements under which the worker would be regarded as an employee (under the normal case law tests) if his services were provided direct to the client rather than through an intermediary company or partnership. If an engagement is caught by the new rules, the gross income received by the intermediary is treated as a Schedule E payment made by the intermediary to the worker (subject to some specified deductions including a 5 per cent flat rate deduction to cover expenses). Schedule E tax and National Insurance (both the employer's and employee's contribution) are payable whether or not the sum is actually paid out as salary. The worker is not treated as an employee of the client for employment law purposes as a result of this legislation.⁷ The aim of this note is not to examine the legislation in detail, as this does indeed require a book, but to ask why this development has caused such concern.

***B.T.R. 2 Objectives and confusion**

The stated aim of the legislation was to "counter avoidance in the area of personal service provision". Press Release IR 35 referred to the possibility that someone could "leave work as an employee on a Friday, only to return the following Monday to do exactly the same job as an indirectly engaged 'consultant' paying substantially reduced tax and national insurance".

This first part of the Press Release suggested that only extreme cases were being targeted but the section headed "details" gave the lie to this. It referred to the need to ensure that people working in "disguised employment" were paying the same tax and National Insurance contributions as those employed directly and stressed the need for a level playing field between businesses. It also made the point that workers not engaged directly as employees lose out in respect of rights to sick pay, maternity leave, entitlement to notice and redundancy pay. This suggested a rather broader attack on the way in which the work force was being engaged than had earlier been implied. This broad approach seemed to be in line with employment legislation from the current government, which had already widened the net of employment protection to some not defined as employees under normal case law definitions.⁸

In addition, the note to IR 35 stated revealingly, "These changes buttress the new measures to support small and medium sized companies. Without these changes it would be very difficult to target support at *genuine entrepreneurial activity*" (author's italics).

The impression the Press Release sought to give was of a cohesive, "joined up" government policy on taxation, employment law and small businesses. In fact, though, the Government has produced legislation which does not achieve its aims and confuses rather than clarifies. It does little to encourage an actual move to direct labour and does not extend employment rights to those taxed as if they were employees under the new regime. It does not deal with the structural problems that result in tax and National Insurance contribution savings for those who are not directly employed. Blanket tax reliefs continue to be an untargeted and uncertain way of directing aid to businesses. At the same time, the legislation creates uncertainty where previously there was a measure of certainty and relies

on a case law test which may struggle to bear the burden of its new role.

What is “genuine”?

Questioned as to how this legislation fits into the Government's drive to support small business, the Inland Revenue's response is that “By tackling avoidance activity, the Government will be able to more effectively target its support for small businesses towards those who are creating wealth and employment”.⁹

This was not the wording used in the Press Release, however. The reference in that document to *genuine entrepreneurial activity* should have alerted officials, if not ministers, to the fact that they were heading for difficulties. What does *genuine* mean in this context? This is a dangerous use of language, which would have attracted a red pen in a student essay. When juxtaposed to references to tax avoidance it might seem to suggest that activity not considered by government to be *genuinely entrepreneurial* is in some way socially unacceptable. The Government may not have intended to cast aspersions on all ***B.T.R. 3** the people who would be caught by the legislation, but its use of language was misguided and this was an unfortunate start.

It is clear that, prior to the introduction of the personal service intermediaries legislation, some taxpayers were entering into highly artificial, marketed schemes, such as composite companies, in order to utilise the tax advantages of not being direct employees.¹⁰ Some were ex-employees whose contracts were re-arranged but who continued to work for just one “client”, their ex-employer. Many others who feel threatened by this legislation, however, do not fall into these categories.

For freelance workers, often providing services only, but in industries where it is customary to operate through limited liability companies and to be paid gross, the message they now received from IR 35 was highly confusing. Those in the IT industry in particular have been encouraged to believe that they are at the cutting edge of the new economy. The rhetoric of government about the importance of small businesses is widespread and often unqualified. All are encouraged to enter the “enterprise culture”.¹¹ To provide incentives to workers to set up their own businesses through the tax and national insurance systems and then to tell them they may not have these incentives because they are not *genuine entrepreneurs*, in fact they are tax avoiders, is to invite fury.

The notion that it is always feasible to identify businesses which are not going to create wealth and employment is misguided. Some individuals setting up in business will start up in a small way, perhaps working from home for one or a few clients only, with the aim of expanding in due course. It is a problem that has dogged small business policy that it is very hard indeed to differentiate wealth producing from non-wealth producing and growing from static businesses.¹²

The majority will not grow and will not wish to, but those few which are going to expand and take on their own employees are precisely those that the Government wishes to target for assistance, even if they are at a very early stage of development. They may not start out with employees, business premises and other attributes of an established business, however, They need to build up capital and clientele to reach this stage. Clearly, though, if a fragile new business without capital or a long client list is to be treated less favourably for tax purposes than a more established one, the former's chances of growing into an enterprise which is wealth and employment creating will not be improved.

To attempt to build a tax policy on this distinction between wealth and employment creating businesses and those which will not develop in this way, between *genuine* and *non-genuine* businesses, is to build on sand. Yet the Government does not seem to have been deterred from this attempt or to have been shaken in its reasoning by the criticism it has received. In a letter in the press in October 2000, Dawn Primarolo, Paymaster General, wrote that

“[W]e were faced with a situation where people who were *not small businesses in the accepted sense* but were in fact little different from employees were able to benefit from the tax treatment intended for entrepreneurs simply by buying an off-the-shelf limited company”.¹³ (Author's italics)

***B.T.R. 4** This negative reference to off-the-shelf companies is totally at odds with the Government's policy on business organisation, which is committed to making incorporation of companies, including buying them off-the-shelf, more attractive and less burdensome than ever. Ease of incorporation is lauded as one of the helpful features of our enterprise culture.¹⁴ To use the term “off-the-shelf” in a derogatory way shows deep confusion.

The real concern expressed here is that in *some* instances the workers who are covered by the

personal service intermediaries legislation will be individuals who are very close to employees in terms of the economic role they are playing. They may bear little risk. This can create inequities and a feeling of injustice amongst those taxed as employees working side by side in these circumstances with those who are treated as self-employed.¹⁵ The problem is that, in their enthusiasm to tackle this very real and difficult problem, the Government has concentrated on the employed/self-employed borderline and ignored the issue of the comparison between very small businesses and larger, more established ones. As we shall see below, the Government was persuaded by lobbyists to place the burden of the new legislation onto the service providers rather than the clients. This shift away from the original policy has had a profound effect on the way the legislation impacts on the system as a whole. The attempt to make the system “fairer” on one borderline has created problems on another.

It is not surprising that one of the lines of attack being used by the Professional Contractor's Group in their judicial review case is that the new legislation amounts to state aid because it taxes small knowledge-based contractors in a materially harsher way than their competitors.¹⁶ Government is comparing these workers with employees whereas some of them compare themselves with more established businesses. The question of which comparator to use is central to the debate¹⁷ but cannot be conclusively answered in general terms since it is a question of assessing all the facts in each case. Even if all the facts at one point in time are known, it may not be clear how the particular taxpayer in question will develop his business. The snapshot approach of the personal service intermediaries legislation cannot do justice to the dynamic nature of some small businesses.

Encouraging employment

The Government purports to be focusing on the lack of equity between employees and the ***B.T.R. 5** self-employed. In addition, the IR 35 Press Release expressed concern for workers who were losing their employment rights by being forced out of the direct labour force. These are real problems, but this concern for employees and those wishing to be employees does not seem to have been carried through in the legislation.

On its website, the Inland Revenue appears to assume that workers have a choice about whether to be freelance or employed, stating “The [IR 35] legislation will allow workers to decide whether to work through a service company or to become a direct employee of the client for business reasons, rather than because of tax and NICs advantages”.¹⁸

This shows little understanding of working practices in the new flexible economy.¹⁹ Outsourcing has taken place for many reasons, tax and National Insurance amongst them, but also to cut the costs of complying with employment legislation. In many cases there are also commercial reasons, linked to efficiency, use of new technologies and flexibility.²⁰ The decision to outsource work is one made by the client firm and not always by the workers, who may have no choice but to freelance if they want to remain in a particular industry.²¹ This is apparent in high paying areas such as IT and the gas and oil industry, but also in sectors such as publishing and the dairy industry, where workers are less well paid. These developments are being recognised by the Government in other areas of its planning²² but are not, apparently, familiar to the Inland Revenue.

The personal service intermediaries legislation gives no incentive to the client of a personal service company to take on the service provider as an employee. The client may be able to continue to avoid employment legislation by using service providers employed by intermediaries²³ as well as making other savings. The burden of compliance with this legislation rests squarely with those working through personal service companies and partnerships, so that the client does not bear any of the risk of uncertainty about whether the legislation applies. Indeed, if there is uncertainty about whether a service provider is an employee or not, the client will continue to be well advised to insist on incorporation by the service provider so that the client bears no risk of penalties if the service provider is incorrectly classified as self-employed. There will be upward pressure on fees from service providers, since the latter will bear increased costs, but this cost is likely to be lower than the total costs of direct employment, especially once compliance costs are added in. So, the ***B.T.R. 6** new legislation indirectly reduces the financial advantages of using workers operating through intermediaries, but does not clearly encourage a move to direct labour.

“Consultation”

Part of the problem with this legislation lies in the fact that it was announced in one form and introduced in another. This was not, however, the result of comprehensive consultation and considered debate. Rather it came about because of an angry response and an unstructured

consultation exercise, which took more account of the views of the large business lobby than of the needs of the workers. Although the changes have in general had a good press, the shift in policy they represent has moved the Government well away from its original intention and has increased the likelihood of successful challenge.

Under the original proposals in IR 35, the engagement would have been covered if the worker was under the control of the client and the personal service intermediary was not on a public register of certified businesses. It would have been the client who would have had the responsibility for deducting tax and National Insurance contributions in these circumstances. These proposals did not use the case law tests for determining employment status, but a rather simple and quite inadequate and outdated test of supervision, direction or control.

IR 35 announced that there was to be no discussion about whether legislation should be introduced or not. It is common enough to refuse consultation on the grounds that anti-avoidance legislation is not for debate. Cedric Sandford has outlined in his latest book on making tax policy that this is one way to deal with lobby groups and it can be successful.²⁴ In this case, however, the legislation was not to have immediate effect and it was promised in the Press Release that the Inland Revenue “would be discussing the practical application of new legislation with interested parties and will work with representative bodies on the production of guidelines”. This was the worst of both worlds. It was not the quick introduction of anti-avoidance legislation (and in any event its target was arguably broader than pure avoidance), nor was there proper consultation.

The Inland Revenue deny that there was no proper consultation, citing the fact that they sent out 1,800 copies of the original proposals and held two consultative meetings with 38 representative bodies.²⁵ Yet this copy of the initial proposals was clearly headed, “*This summary is for use as a basis for discussion but is not a consultation document*”. The less bold and those not used to dealing with the Inland Revenue could be forgiven for thinking that there would be no point in making radical comments and that they had to confine themselves to tinkering with the details. In these circumstances, the quality of the response received was a tribute to those representative bodies which took the trouble to deal with the issues, but it is not surprising that those representing larger businesses and their advisers had a strong influence.

One only has to compare what took place with the Cabinet Office's code of practice on written consultation²⁶ to see that this process was *not* a proper consultation. The discussion document was stated not to be consultative, although in fact it turned out that it was, so the document's purpose was unclear. Initially it was sent only to those who had responded to the IR 35 Press Release²⁷ and was not available on the Inland Revenue website or otherwise ***B.T.R. 7** effectively drawn to the attention of all interested groups. It was the Professional Contractors' Group and others who provided the publicity for the document which resulted in the large number of requests for it. There were no clear deadlines for response. Though meetings were held, these were not advertised and were open only to invitees. This resulted in reports of “secret meetings”.²⁸ The Inland Revenue often consults with representative groups in this way, but in relation to a topic which had already attracted widespread concern from parties often not concerned with taxation technicalities, more care should have been taken.

It was this imperfect process which resulted in the shift of burden to the workers from the clients and undermined the original aim of moving workers back into direct employment. The impact of the legislation on small businesses gained a higher profile than it would have done under the original proposals. The crude control test originally proposed was replaced by the existing case law test. This has been heralded as an improvement and, given the time scale, may be the best that could have been done, but a more radical examination, properly conducted, could have resulted in something better.

Had there been more time, some overseas jurisdictions could have been examined, for example. Australia has just introduced similar legislation, which contains a special test for when a person is carrying on a business in this context, including safe harbours.²⁹ Once it was decided that the burden should shift to the personal service intermediaries, it might also have been worth considering whether the problem could have been tackled by more general corporation tax rules as in Belgium. There, at least one director of a company claiming the decreased corporate tax rate for small and medium sized enterprises must receive a minimum remuneration of a certain amount, which is subject to social security contributions and individual income tax.³⁰

As it was, the uneasy and forced “consultation” which resulted from public pressure rather than an

Inland Revenue willing to engage with its public has produced not only anger, but also a system which does not achieve the Inland Revenue's original aims. In addition it is costly both in terms of administrative and compliance costs. It remains to be seen whether it produces sufficient revenue to make all this worthwhile.

Have taxpayers over-reacted?

It might be argued that the reaction of the Professional Contractors Group and others has been unnecessarily vehement.³¹ If workers are not in fact employees under the normal case law test, they have nothing to worry about under this legislation. It is probably true that the furore has been excessive, due in part to the way in which the Government chose to present its case. What the new legislation does, however, is to deprive workers at the border of self-employment of a safety valve that had been evolved over a number of years. The personal service company, de facto, has served to reduce the amount of uncertainty surrounding employment status under the case law rules. Some unfairness *vis-à-vis* employees has resulted from this use of intermediaries, but the removal of this safety valve, without the creation of any other in its place, will result in pressure mounting on those case law rules so that an increase in litigation seems inevitable.

***B.T.R. 8** The case law seeking to define the employed/self-employed borderline has been stretched to its limits in dealing with service-only providers, though it has in fact responded flexibly and the state of the law, if properly applied, is not as bad as some have suggested.³² It is often suggested that the case law is creaky and inadequate for new economic conditions.³³ It is true that the tests may be rather too much linked with the particular circumstances at any one time and not be fully capable of taking into account plans for future development. This makes it difficult to cater for newly started businesses in the process of building up.³⁴ But the problem is not so much that the case law has not developed: it has. Rather, the difficulty is that the application of this law, evolved through cases and entirely dependent upon its facts, is a cumbersome and uncertain method of making important distinctions. Correct application of the various factors requires knowledge not only of a particular engagement but also of surrounding circumstances. The process of weighing up the different factors is one for which no formula exists.³⁵

The Inland Revenue's attempt to assist with application of the tests, by producing a detailed new Employment Status Manual, published on its website, is welcome and the Manual is probably as helpful as it could be in the circumstances. The level of detail it contains and the number of factors it lists for consideration serve mainly to highlight how complex the area is, however. Although in theory the manual gives increased accessibility to detailed advice, in practice it is overwhelming to all but the most hardy of lay people (and to many professionals also). In addition to the Manual, there is more compact guidance on the application of employment status rules to workers using intermediaries (first published in the Tax Bulletin in February 2000). This, however, also reveals a multi-factorial test that will be very hard to apply in the very borderline cases where it is most needed. This is not, of course, the fault of the Inland Revenue's guidance but is in the nature of the test.

In another welcome move, Inland Revenue status opinions are being provided to personal service intermediary owners on receipt of full details and the Inland Revenue aims to deal with requests within 28 days.³⁶ Quick though this may seem for a public body, however, it is slow in commercial terms. This is especially so since the Inland Revenue will not comment on hypothetical contracts. Yet it is impossible to price a contract until tax and National Insurance status are agreed. The pressure on the Inland Revenue from taxpayers needing fast replies is likely to be very great.³⁷ Thus, failure to consult more fully on a more easily applicable test may have resulted in a good deal of extra work for the Inland Revenue, though this culture of willingness to give rulings on status may have general benefits in the future. The old case law test is now centre stage. The starring role it must play in this new scenario may prove too much for it to bear, though it may prove sufficiently adaptable. The application of the new legislation by the Inland Revenue seems to be somewhat more sophisticated than their original approach when formulating the rules. The existing case law test is better than the crude control test in the original IR 35 ***B.T.R. 9** proposals, but the test of tax reform should not be whether we can improve on a bad proposal. We should ask whether the reform meets the objectives set for it without creating problems of another kind.

Overall, tested on whether it achieves the Government's own aims of achieving fairness between different groups of taxpayers, encouraging direct employment and targeting tax breaks to wealth creating small businesses, this legislation leaves much to be desired. The judicial review hearing will raise many issues which could have been avoided by a greater willingness to enter into discussion

over a sensible period of time. Whilst some personal service intermediaries mask “disguised employment”, which does need to be addressed, others could be tomorrow's entrepreneurs. The problem of dealing with these two groups appropriately needs a radical and comprehensive review of tax, National Insurance and employment law, looked at as a whole and not as a quick-fix tax avoidance exercise.

J.F.

B.T.R. 2001, 1, 1-9

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1. Budget Press Release March 9, 1999 ([1999] STI 469).
 2. Anne Redston, *IR35: Personal Service Companies* (abg, London 2000).
 3. www.inlandrevenue.gov.uk/ir35.
 4. www.pcgroupp.org.uk
 5. [2000] STI 1481 *et seq.* The detail of the judicial review case will be discussed in a future issue.
 6. FA 2000, s.60 and Sched. 12.
 7. Although see footnote 23 below.
 8. See Employment Relations Act 1999 and the National Minimum Wage Act 1998, for example.
 9. www.inlandrevenue.gov.uk/ir35/faqsgeneral.htm (hereafter FAQs), question 10.
 10. Redston, *op. cit.* p. 6.
 11. For the latest manifestation of this rhetoric see Gordon Brown's pre-budget statement November 8, 2000.
 12. D. Storey *Understanding the Small Business Sector* (Routledge, London, 1994).
 13. *Evening Standard* October 25, 2000.
 14. See for example the rejection of barriers to incorporation in The Company Law Review Steering Group's *Modern Company Law for a Competitive Economy: Developing the Framework* (DTI, March 2000 at p. 305).
 15. See for example, M. Harvey, *Towards the Insecurity Society: The tax trap of self-employment* (Institute of Employment Rights, London, 1995) at p. 7 shows how workers with different status for tax and insurance purposes can be found working side by side. There is anecdotal evidence that employees consider that their tax treatment is unfair, for example in relation to the expenses rules, but there is little written evidence of employees complaining about this. Presumably those who feel strongly about this have, in the past, moved to freelance work themselves. As pointed out in the IR 35 Press Release, businesses trying to use direct labour are put at a disadvantage by the higher costs, including National Insurance Contributions, of employment. Most of the written evidence shows the other side of the coin, however: that is that the self-employed are losing out on employment protection and other benefits of employment, see for example B. Burchill, S. Deakin, S. Honey, *The Employment Status of Individuals in Non-Standard Employment*, URN 98/943 No. 6, EMAR Employment Relations Research Series, DTI.
 16. Professional Contractors Group Judicial Review Background Briefing, October 2000.
 17. It is also important to another question raised under the judicial review case--the question of breach of the right of establishment under the EU Treaty.
 18. Question 27--IR 35 FAQs.
 19. For a fuller discussion of changing work practices, see J. Freedman, *Employed or Self-employed--Tax Classification of Workers and the Changing Labour Market* (IFS, 2001) based on work undertaken for the Tax Law Review Committee. That paper and this note, however, are written in the author's personal capacity and should not be taken to represent the views of the Tax Law Review Committee. See also J. Burton, *Inflexible Friend--The new flexible economy and professional services* (Adam Smith Institute, London, 1999, chapter 3).
 20. A. McGregor and A. Sproull, "Employers and the flexible workforce" *Employment Gazette* (May 1992) 225.
 21. Harvey, note 15 above; C. and J. Stanworth, "Reluctant Entrepreneurs and their Clients--The Case of Self-employed Freelance Workers in the British Book Publishing Industry" *International Small Business Journal* (1997) 16.1. p. 58; E. Boyle, "The Rise of the Reluctant Entrepreneurs" *International Small Business Journal* (1994) 12.2. p. 63.
 22. See for example two reports written for the DTI: Burchill *et al.* n. 15 *op. cit.* ; The Future Unit, *Work in the Knowledge-Driven Economy* (DTI 1999).
 23. An employment tribunal may be prepared to look through the corporate veil as in the case of *Catamaran Cruisers v. Williams* [1994] IRLR 389. Nothing in the new legislation affects this directly though it remains to be seen whether the tax and NI legislation will have an indirect effect on employment tribunals--see Freedman n. 19 above.
 24. C. Sandford, *Why Tax Systems Differ* (Fiscal Publications, Bath 2000).
 25. Question and answer 8, IR 35 FAQs.
 26. Cabinet Office, Code of practice on written consultation, November, 2000.
 27. Redston, *op. cit.* pp. 7-9.
 28. Professional Contractors' Group website.
 29. *New Business Tax System (Alienation of Personal Services Income) Bill 2000*.
 30. Belgian National Report delivered at European Tax Professors' Conference on the Taxation of Small and Medium-sized Enterprises, Stockholm School of Economics, June 1999.

- [31.](#) See, in this vein, M. Peel, *Financial Times*, October 12, 2000.
- [32.](#) *Hall v. Lorimer* [1994] STC 23 has been cited extensively by those seeking to show that service only providers may nevertheless be self-employed for tax purposes. For a fuller discussion of this case law see Freedman, cited note 19 above.
- [33.](#) For example, see E. Troup, *Financial Times*, September 30, 1999.
- [34.](#) See, e.g., Redston p. 115.
- [35.](#) *Barnett v. Brabyn* [1996] STC 716.
- [36.](#) Inland Revenue Press Release February 7, 2000 ([2000] STI 149).
- [37.](#) By July 2000, 1,200 contracts had been sent to the Inland Revenue for review--ICAEW Taxguide 6/00.

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