

# Office of Tax Simplification

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## Employment Status report

March 2015



Office of  
Tax Simplification

**Employment Status report**

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# Foreword

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This is the Office of Tax Simplification's report on the last formal project of its current incarnation. As always, it contains a range of simplification recommendations – but this is a wide-ranging and long-range project, so we are aiming to stimulate debate on how the issues we identify are tackled.

In tackling the knotty subject of Employment Status some have said we saved the best – or perhaps the biggest – until last. That isn't quite fair: many of our other projects have been on major areas of the tax code (small business taxation for example) and some have undoubtedly had a big impact (employee benefits and expenses being a prime example). But employment status is a complex and wide-ranging subject that many have said has no real solution – and that if we did manage to 'solve it', we should immediately move on to world peace as we'd clearly be on a roll.

## Principles of the project

So why did we light on employment status – and what are we seeking to achieve? The 'why' comes back to our mandate: to look at areas of the UK's tax system that are complex and/or cause difficulties in practice, and develop recommendations for simplifying the rules and procedures. Previous projects, particularly small business (where businesses said employment status was the fourth greatest source of complexity for them) and employee benefits (when status issues came into many conversations), had shown employment status was a problem in practice. All the evidence we found suggested it was a problem that, due to changing work patterns, was getting worse. There is also the issue of individuals (particularly the low paid) being 'forced' into a form of self-employment. Employment status came out on top of the list of possible projects we discussed with a consultative group; and HM Revenue & Customs, HM Treasury and the Department of Business, Innovation and Skills (BIS)<sup>1</sup> all recognised it as a subject that needed looking at.

What are we seeking to achieve? Ideally we would 'solve' the problem – but we were clear from the outset that we were highly unlikely to get to a solution in the timeframe available. Instead, our broad agenda has been:

- (i) To test whether there really is a problem here (some suggest there isn't – or at least that it is something that is easily dealt with)
- (ii) If there is, why is it such a problem – what are the underlying causes and trends, and how might these develop (any solution or improvement must work for today and the future)
- (iii) Develop and assess possible routes to improve the situation, aiming to identify some promising routes for full exploration (and potentially rejecting some as unlikely)

As our work progressed, it has become clear that improvement routes could be categorised under two broad headings:

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<sup>1</sup> Indeed BIS have been engaged on their own, largely internal, review of employment status questions. The two projects have different goals – ours naturally has tax issues in mind, BIS are looking at the impact on businesses and innovation – but they clearly overlap so we have been liaising closely during our work.

- direct – actually tackling the definitions inherent in employment status
- indirect – changing rules (tax and possibly others) that would take the heat out of the issue

## The wider environment

It rapidly became clear that, as we had hypothesised, the tax system is still in many ways stuck in an out-of-date mindset: of categorising workers as either employees, firmly on the payroll, or self-employed, with the traditional jobbing plumber in mind. This made sense in the 1950s and 1960s but the huge growth in freelancing as a way of life (and work) doesn't fit readily into this traditional model. That growth stems from the IT industry, but has spread far beyond it, facilitated by the internet and (nowadays) 'apps'. Some people may be forced into this form of working but more choose it and value the flexibility it brings. All of this leads some to suggest that the tax system needs to recognise a 'third way' of working.

The pressure for change also comes from businesses where they are trying to control costs and in particular exposure to unexpected claims for employee rights from people they had regarded as contractors. The EU law concept of 'worker' has also had a significant influence. Many businesses have told us that their 'solution' has been to mandate that anyone working for them either comes on the payroll (which in many cases they don't want as they seek to control numbers and maintain flexibility) or to work through an intermediary (a personal service company or an agency).

## Solutions

So have we found a solution? As we anticipated when we set out, we have not found the tax equivalent of the philosopher's stone that will suddenly transmute all the base problems into shining clarity. We have certainly proved there is a problem and set out why – and established that there is a real need to improve the situation. We have tested a range of routes and found some to be more promising than others. The best need taking further and we would welcome input from our many stakeholders on how to do so. These are of course difficult issues to tackle and it may be that making a significant improvement will require some hard decisions.

## Acknowledgements and next steps

Many people deserve thanks for their contributions. We have again had a huge amount of input from representative bodies, businesses and HMRC staff. We have particularly welcomed the engagement we have had with a range of Unions and bodies of individual workers. Our Consultative Committee members have been invaluable and we must not forget the 340 people who completed our on-line survey. All the input we have received has been studied and taken into account.

The greatest thanks go to our project team, all of whom have committed a good deal more time than their agreed days, such (we assume) has been the pulling power of this fascinating subject. They are Roger Bennett, Marian Drew, Ed Kaye, Rebecca Seeley Harris and Andy Richens, with a particular thanks going to Ed's employers, Grant Thornton, for generously making his time available to us. We are also grateful to Lik-Kee McKaine of HMRC who helped us significantly for the first half of our project before having to return to full-time HMRC work.

We hope our report finds favour with Ministers. We anticipate an immediate reaction in the coming Budget, but this is something that (together with the future of the OTS) will be in the in-trays of Treasury Ministers of the next Government. In the meantime we encourage interested parties to let us know in the next few weeks what they think of our conclusions: we plan to

prepare a summary of comments received to sit alongside our report. We also hope to participate in a conference in the summer on the issues we have raised. Do let us know at [ots@ots.gsi.gov.uk](mailto:ots@ots.gsi.gov.uk).

A handwritten signature in black ink, appearing to read 'John Whiting'.

John Whiting

Tax Director, Office of Tax Simplification





# Executive summary

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The OTS has studied Employment Status because it was identified as an area of difficulty in the tax system in several of our earlier projects. It was endorsed as a project by soundings we undertook in mid-2014. Employment status is a subject that all parties with whom we traditionally deal – businesses, individuals, agents, HM Revenue & Customs (HMRC) and HM Treasury (HMT) – see as an area that needs to be addressed. But our study has also attracted interest from wider groups, including the Department for Business, Innovation & Skills (BIS).

Our Terms of Reference for the project are included as Annex J. These can be summarised through one of the initial sentences: “The Government has therefore commissioned the Office of Tax Simplification to examine the dividing line between employment and self-employment and whether it is drawn in the right place and in the right way.”

We were asked to produce a report in time for Budget 2015. The intention was that the report would contain any appropriate ‘quick wins’ that it may be possible to take forward quickly. However, it was seen as likely from the start of the project that if the report points the way to significant reforms, these would be for the next government to consider.

## What is employment status?

An individual’s status as an employee (or not) is something that affects issues beyond tax – employee rights, national minimum wage, benefits and credits, pensions auto-enrolment (a significant new factor in the minds of many businesses) and others. Our work and report focuses on tax and we use the term ‘employment status’ in this context, but we have tried to have proper regard to other, related aspects. We are conscious that taking forward some of our ideas will require joint working with government departments beyond HMT and HMRC.

## Is there a problem – if so, what is it; and why is it there?

We set ourselves the task of considering a range of background issues to underpin our work:

- Is there really a problem here?
- If so, is it something that is increasing?
- What are the drivers?
- What is the legal position?
- What is the position of a variety of particular occupations?
- What international experience and examples can we gather?

Our conclusion is that there is undoubtedly a problem, it is a growing one (though perhaps not as fast as it has been) and that a key issue for those affected (businesses and individuals) is the lack of certainty. Chapter 1 of our report gives considerable analysis of the current situation. The evidence from other countries (see Chapter 5) is that all have recognised the issue – but approaches to managing it differ.

From this and our evidence gathering it is clear that the drivers for the uncertainty and for employment status being a problem are varied:

- changing work patterns
- a desire for flexibility – both from businesses (for their workforce; also simply managing numbers) and from individuals (as a way of working)
- for business, managing the risks involved, both tax exposure and (probably more significantly) exposure to claims for employment rights
- the lower tax cost of self-employment (mainly NICs, but also expenses)
- administrative burdens of employing people

The assumption may be that NICs saving was the main driver for all concerned: this was undoubtedly a significant issue for many individuals but businesses' main concern was being clear on employment rights. Hence their main driver was risk management – with the solution usually being to only engage people (if they were not on the payroll) through an intermediary entity (personal service company, agency or umbrella).

The consequences of the employment status problem include:

- uncertainty
- risk for business (exposure to tax errors and unexpected claims)
- individuals not getting the tax treatment they expected
- HMRC not collecting the correct tax/NICs
- time-consuming disputes
- administrative burdens in resolving matters

It is clear that all parties – including HMRC – find the rules difficult to manage, particularly with the way case law continues to evolve.

## Developing our ideas

We have, as always in our work, consulted widely. A list of the groups and representative bodies we have met or had written input from is in Annex A. In addition we gathered input from an open online survey which attracted 340 responses. We have summarised the responses from our survey in Annex C. Our recommendations draw on all the views and evidence we have received.

In developing our ideas, we kept coming back to three key points:

- 1 The tax (mainly NICs) differential between employees and the self-employed is significant; as long as it exists there will be pressures on the employment status boundary from those who wish to gain an advantage or manage the risk of getting it wrong.
- 2 Often of greater significance to business is the issue of employee rights.
- 3 Because the dividing line for employment status is blurred rather than clear, it brings a lack of certainty and invites attempts to 'game' the rules.

These are not academic concerns: as will be appreciated, getting the position wrong can be expensive (usually for the 'employer'). But businesses are usually able to manage the

employment status issue, though sometimes this can turn into manipulation and give them an unfair competitive advantage.

One aim could be summarised as ensuring that there are no differences in tax/NICs treatment or employment rights, now or in the future, for people who in reality are all employees in the everyday sense of the term, however they are engaged. The difficulty is of course in defining exactly where various dividing lines fall.

## Lessons from abroad

As part of our work we have researched widely how other countries deal with employment status. It is clear from our work that all countries have the issues to a greater or lesser extent – and also that none have found a perfect solution.

It is notable that some countries – Canada and Brazil are examples – have relatively minor differences in the tax and social security impacts on the employed as against the self-employed. Thus although they have no clear and simple dividing line between the two statuses, they do not have a significant tax-driven problem.

We summarise the main points we have found in our work on other countries' systems in Chapter 5, with fuller treatment in Annex I. Four of the most interesting practices are:

- USA: there is a definition of employed status, known as the 'ABC' test. This sets three criteria and all have to be satisfied for the individual not to be an employee. Thus the default is employment.
- Ireland: greater use of withholding taxes from the non-employed. As well as an equivalent to the UK's Construction Industry Scheme (which applies beyond construction) there is a withholding tax applied to the non-employed working for (broadly) public bodies.
- Australia: the 80/20 rule helps decide on employment status. If a contractor derives 80% or more of their income from one client, PAYG (equivalent to PAYE) must be applied. There is also a 'wholly or mainly labour' test to be applied to the relevant supply to assess how tax is to be applied.
- Germany: an elective system is in use to allow individuals to opt for one status or another. There are conditions and consequences of course, but one underlying benefit is that the individual (and their engager) is clear about their tax and employment status.

## Improving the position

We have considered improvements to the current rules (i.e. better definitions of employment status) as well as new routes to solve the problem. The new routes may well be indirect, in that they could make the problem less significant rather than solve the actual employment status problem directly. This has led us to split the report into three sections:

Part I – Setting the scene

Part II – Direct routes to improve the current situation

Part III – Indirect routes to take the heat out of the problem

It must be stressed that we have found no easy or immediate solutions. This is as we expected when we set out on the project. Most of the ideas we raise would mean significant change and taking them forward will necessitate careful consideration with full further consultation, all over a significant timescale. We are conscious, too, that change is itself a complication rather than a simplification, though the aim is always for a simpler end point.

There are no obvious quick and easy improvements that could be made to achieve a useful difference to the employment status situation. Thus there are no 'quick wins' here of the sort that feature in many of our reports. We do, though, believe there are improvements that could and should be made to HMRC's guidance and procedures: these would take time and effort but they would certainly help and may be things that could be committed to quickly. Our recommendations in this vein are in Chapter 7 and include in summary:

- better guidance for those who need to resolve an employment status issue
- a route for those with a genuine difficulty to talk to an expert quickly and get a ruling – though that raises the question of how to manage demand as well as guarding against abuse
- developing rules for an evidenced 'audit trail' to give certainty and protection against reopening of prior years

This may encompass an enhanced status for HMRC's online Employment Status Indicator tool (ESI – see Chapter 8). We see potential for this being developed; possibly into more than one system (to cater for different industry sectors). But one hurdle that needs to be overcome is the widely held perception of users that the ESI is biased towards finding that an individual is employed. Similarly, HMRC are perceived as having a default response of 'employed'. Neither perception is wholly fair – it is interesting that the statistics of ESI usage (see Chapter 8) do show more self-employed results than employed. Also, HMRC try to get to the right answer, which may be unpalatable to users.

We regularly heard calls for HMRC to enforce the existing rules better than they are seen to do. People cited examples of practices that are not in line with employment status rules becoming established in industries. Although these help administration and can deliver certainty – two of the OTS's objectives – the objections being raised were in terms of fairness to those who were not benefitting from what were seen as reduced tax bills. At times these concerns were linked to a loss of employee rights for those affected.

Linked to the questions about HMRC's enforcement are questions about particular occupations that have established agreements or rules (see Chapter 3). Many of the agreements need to be revisited to ensure that they remain fair and balanced in today's environment. Separately, there are still some Categorisation regulations in place which can result in NICs treatments differing from income tax. It is difficult to see how these can continue to be justified: there should be harmonisation of NICs and income tax rules. So we feel there should be a review with a view to their abolition, though we acknowledge that they are well established and understood so those affected do get certainty.

It might also be possible to look in the medium term at the possibilities of evening up expenses between employment and self-employment. There is an existing HM Treasury consultation about travel and subsistence rules for employees, stemming from the OTS reports on employee benefits and expenses. Our report recommended some interim improvements to the rules and a longer term review; we await with interest the results of the current consultation.

## Longer term ideas to explore

An interesting theme that came up in many meetings was the issue of whose job it is to prove the employment status of an individual. The main onus is currently on the business (hence the tendency to 'solve' the situation by hiring only through an intermediary). We acknowledge that there is a risk in some of our recommendations that the onus moves to HMRC too readily: that would need to be managed. But we think there is a need to put more of the onus/responsibility on the individual. This has obvious risks – in many situations the individual would not be equipped to decide, but that emphasises the need for better guidance and a route to getting a ruling that can be relied on. It also makes a system that has a default result more attractive.

Something that would help many businesses would be a set 'de minimis' level in the employment status (ES) area. The principle would be that someone who is paid under a set amount or works for less than a defined period would never be regarded as an employee. We discuss this further in Chapter 6 and it is clear that there are a number of risks in such an approach – for example, unscrupulous employers might force employees to take a succession of 'de minimis' roles, but it is an idea that is worth exploring.

We think that a statutory employment test needs to be explored further: see Chapter 9. We recognise all the difficulties inherent in trying to express employment status as a set of rules but there are clear attractions if this can be done. There are two approaches possible:

- a detailed, complex exposition that would aim to reflect all relevant case law
- a simple or pragmatic set of rules that would have rough edges

There was a lot of support for exploring the idea, though much of that support was predicated on the statutory employment test applying 'across the board' – so to employment rights in particular and areas such as benefits and auto-enrolment. This is a key point that needs to be explored: whether or not we end up with a statutory rule, there is an almost universal call for rules to apply to both tax and employment rights. That may not be possible given that employment rights follow from employment law and are outside the control of the tax authorities. But there would be huge benefits in harmonised rules and the possibilities need to be explored.

An indirect route that could well help many situations is to introduce a withholding tax in some situations. We discuss this in Chapter 11. This would not just be enlarging the Construction Industry Scheme, but a deduction of tax (perhaps at a fixed proportion – say 75% - of the basic rate of income tax) at source from payments where employment status is in doubt. It could offer protection for businesses against unexpected liabilities; although it might damage immediate cash flow for some individuals, it might actually help with budgeting for their tax bills. It would naturally place demands on HMRC's IT system to tie up payments and credit taxpayers appropriately.

We have also looked at the idea of a 'third way' – an intermediate status between employed and self-employed – in Chapter 12. There are possibilities in this route but there are also downsides and problems. Overall we are not recommending it as a way forward but we do not dismiss it and would welcome further input addressing some of the issues we highlight.

If progress is to be made in 'solving' employment status as an issue, it is difficult to see how this can really be made without tackling NICs: the differences between NICs and income tax and of course the differing NICs rates. The OTS has recommended the integration of income tax and NICs in the past in a number of our reports and we do so again in Chapter 10. There is a strong

case for evening up NICs (and consequent benefits entitlement) between employment and self-employment (ignoring employers' NICs at this stage).

But employers' NICs is the real 'elephant in the room'. It is not an easy thing to tackle, given the money it raises, but it is key to 'solving' the employment status issue. If it could be tackled, many of the problems go away – though differences around employment rights would remain. We have some ideas for making progress here but the starting point is more honesty and transparency about the levy: if more people realise how much it costs/raises, would there be more support for looking afresh at how to raise the money involved?

## **Taking things forward**

The overriding aim must be to develop ideas that lead to simpler rules that can be readily applied in practice (and are easy to enforce): that is the call we have heard all the time.

We repeat that most of the ideas we raise would mean significant change and taking them forward would necessitate careful consideration with full further consultation, all over a significant timescale. It may be that the OTS, if it is retained as an entity by the next government, would be asked to develop some of the ideas we have set out. Whether we or others do so, one challenge to be borne in mind is whether changes really will deliver simplification. Although there is undoubtedly a problem to be solved here, there is undoubtedly a risk that in seeking to improve the situation, changes would add net complexity.

## List of recommendations

There now follows a list of the recommendations set out in the body of the report, cross-referenced to the relevant Chapters and paragraphs.

### Chapter 2 – Legal background

- 1 It is recommended that there is a joint review between the HMRC, HM Treasury, the Department for Work and Pensions and the Department for Business, Innovation and Skills which looks at the possibility of developing an agreed code of principles on employment status. In any event, there should be work carried out, preferably by a joint group, to develop better guidance for the average individual and small business of the rules on employment status. (para 2.86, Box 2.H)

### Chapter 3 – Particular occupations

- 2 We note that the administrative practice in EIM 03002 is under review but we do have concerns that the document proposing its withdrawal did not have regard to the situation of GPs and related professions. We trust that such considerations are being taken into account in considering the way forward. (para 3.14)
- 3 ESC A37 and the related NIC Regulation 27 should be put into legislation to give greater certainty. (para 3.18)
- 4 HMRC should publish updated guidance on the status rules for the film, TV and production industry, with clear signposting from the gov.uk website. (para 3.28)
- 5 Easements and concessions for particular occupations should be formalised in HMRC Statements of Practice and given proper publicity. In particular film industry grading lists and the basis of any agreements should be fully set out within HMRC guidance. All these arrangements should be consistent for both tax and NICs purposes. (paras 3.34 and 7.44)
- 6 We recommend that a review be launched into the categorisation regulations, with a view to their abolition. The aim would be to have a single set of rules, rather than a range of rules that override the main rules in some circumstances and which can result in differing treatments of the same income for income tax and NICs purposes. (para 3.52)

### Chapter 4 – Office holders

- 7 From a simplification point of view, our instinct is that the term ‘office holder’ is outmoded and a source of confusion, and that any distinction between this and ‘employment’ should be abolished in the tax legislation. This would apply to income tax and NICs. However, we have not heard of any real difficulties with the term in practice, so we would be interested in hearing from anyone who is experiencing particular problems with the operation of the ‘office holder’ concept or who has experience of unexpected results arising from its application. (para 4.9)

### Chapter 5 – International comparisons

- 8 The overall recommendation from our international studies is that there are lessons from a number of other countries that can usefully be drawn on for the UK. The OTS has accordingly utilised the data in the report. (para 5.32)



## Chapter 6 – Managing in practice

- 9 The idea of a set de minimis level for payments to an individual who carries out some activities for a business, which would definitely not be an employment, should be explored. This might be in terms of time spent or payments made and could link to the withholding tax idea discussed in Chapter 11. (paras 6.15, 6.32)

## Chapter 7 – HMRC administration

- 10 All of the government's guidance material on employment status should be brought together in some form of 'employment status portal', covering both tax and employment rights. (para 7.4)
- 11 HMRC should issue guidance on the types of documentation and actions they would expect to see a business take when engaging a self-employed individual (in effect, a document setting out 'what good looks like'). (para 7.8)
- 12 There is considerable merit in the idea of a 'safe harbour' basis that balances businesses' need for certainty with the risk to HMRC:
  - (i) We recommend that further work is carried out on the idea and how it might be developed,
  - (ii) The main aim would be that an HMRC employment status ruling could apply from the date of the ruling, but could not apply retrospectively.

We think this is an issue that needs to be explored further and would welcome HMRC's comments. (paras 7.19, 7.26)

- 13 HMRC should set up an employment status helpline, where businesses are able to discuss specific queries with an HMRC officer with specialist knowledge of the subject. (para 7.29)
- 14 HMRC guidance should have more examples of common real life situations and show how employment status case law applies to them. (para 7.30)
- 15 HMRC should consider allocating more resources to employment status and/or ensure that more HMRC employer compliance staff receive specialist training in this area. We see this fitting with HMRC's 'once and done' approach. (paras 7.37, 7.42)
- 16 IR35 is outside the OTS terms of reference for this project but inevitably we have had regular points raised on the subject. We have seen the reports of the IR35 Forum and it would seem pertinent to explore if there is any synergy between the recommendations for IR35 purposes and those of the OTS under this employment status review. (para 7.45)

## Chapter 8 – Employment status indicator tool

- 17 The case law underpinning HMRC's Employment Status Indicator tool (ESI) needs to be reviewed and updated, ideally in an open and transparent way, perhaps by establishing a working group. (paras 8.8, 8.19, 8.46)
- 18 We believe that the ESI is valuable and should be maintained and improved; we note a number of points to contribute to HMRC's current upgrade work:

- (i) Inclusion of more 'real-life' business examples (para 8.38)
  - (ii) Taking that point a step further, consider using more industry-specific questions, which could appear depending on previous answers. (para 8.39)
  - (iii) Some of the supporting guidance and help functions need to be improved to give clearer answers. (para 8.42)
  - (iv) The software needs to be improved to prevent 'freezing'. (para 8.44)
- 19 Two general points need to be considered as part of the upgrade work:
- (i) Consideration needs to be given to developing two (or possibly more) versions of the ESI to apply to different major industry sectors. (para 8.39)
  - (ii) Who is the main target of the ESI tool: individuals, businesses (small or large) or agents? This should influence its presentation and content. (para 8.41)
- 20 Many businesses and representative bodies also indicated that if the ESI tool is properly and reasonably completed (a concept that would clearly need to be defined), then the results should be definitive. We recommend that this is explored in the context of the 'safe harbour' idea at recommendation 11 above. (para 8.43)

## Chapter 9 – A statutory employment test

- 21 The OTS believes that the statutory employment test is an idea that needs to be taken further. The sequence should be:
- (i) Discussing whether (or how) other parts of government would be prepared to apply such a rule in the same way.
  - (ii) Developing a discussion paper based on the points in this Chapter, incorporating the results of the 'whole government' approach.
  - (iii) Testing the ideas in the discussion paper in some workshops with relevant stakeholders.
  - (iv) Working up a proposal based on the most promising route (which would decide whether the detailed or simple route was the preferred option, for example) for consideration by Ministers.
  - (v) Full consultation before a decision to proceed. (para 9.53)

## Chapter 10 – Tax/NICs differences

- 22 The issue of expenses is significant in the context of tax/NICs but we have not investigated this issue properly because of the restriction in our terms of reference. We are aware of the current HM Treasury review of travel expenses, following on from our own work, and hope this will be pursued properly. However, the HM Treasury review focuses on employees' expenses and it seems to us that there is a need to expand the review to look at the position of the self-employed as well. What we have heard leads us to conclude that there is a need for a proper review

of the rules around expenses, to ensure that these are appropriate for current working practices. (para 10.23)

- 23 There should be a full study into the alignment of tax and NICs payments and benefits across the employed and self-employed. (para 10.46)
- 24 The OTS reiterates the recommendations made in its Small Business Review, that merging tax and national insurance would remove many of the anomalies within the tax system, and contribute significantly to simplifying issues around employment status by reducing the differentials. (para 10.50)
- 25 Tackling employers' NICs is the key way of taking the heat out of the employment status issue. The OTS believes there is no easy way to abolish employers' NICs, but an important first step would be to increase transparency around them and hence the understanding of the average individual of how much is being paid in what is, in effect, a payroll tax. That might provoke a better-informed debate on how best to reform the tax. (para 10.65)

## **Chapter 11 – Deduction of tax at source**

- 26 We consider that the concept of a wider withholding tax for payments to the non-employed should be explored. This would not be a simple expansion of the Construction Industry Scheme; instead it would be a new system that took advantage of digitization to establish a simple and responsive deduction system that translated easily into payments on account. (para 11.63)

## **Chapter 12 – A third way**

- 27 We do not recommend developing a new 'third way', i.e. an entirely new employment status in the tax system at this stage. Although the route has possibilities, there seem to be many difficulties in establishing it fairly and we think other routes have more potential. We do not rule out returning to the idea, especially if its proponents can address some of the issues we identify. (para 12.31)
- 28 We think that there is merit in reiterating our previous suggestion of a full review of the taxation of small businesses. That could cover limited companies, partnerships/LLPs and sole traders, and would have regard to employee taxation. (para 12.28)

Part 1:

# Setting the scene

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## Employment environment

**1.1** What is the world which the tax regime has to accommodate? Has the world changed, are the tax definitions fit for purpose? As the employment market becomes more complex the attractions of a simple tax regime increase, for each tax wrinkle, when applied to a changing market, increases uncertainty and the potential for unintended consequences (for example by increasing the scope for employment/self-employment boundary arbitrage).

**1.2** A review of the figures immediately brings into the overall discussion the issue of individuals who economically have all or many of the characteristics of the self-employed, but who carry on business in the legal form of a company. Where an individual is both a shareholder (perhaps with a family member) and the sole employee of a company, the entity is known as a 'personal service company'. Depending on the purpose of the statistics such companies may or may not be included as self-employed, and this is shown below. A particular tax regime (IR35) applies to such companies. Although that regime is outside the scope of this report personal service companies cannot be ignored in any discussion of employment status.

## Labour services

**1.3** The employed and self-employed provide labour services. The total in work population, comprising employed and self-employed, in various guises (see below), was 30.8 million in the latter part of 2014.<sup>2</sup>

**1.4** There is differing, but not necessarily conflicting, information on the number of self-employed within the working population:

**1.5** The Labour Force Survey provides a snapshot based on a sample survey of individuals who self-declare their status at a moment in time in relation to paid work in a 'main job'. Its most recent estimate of the number of self-employed is 4.5 million, of whom 3.2 million were full-time and 1.3 million part-time workers.<sup>3</sup> These figures include personal service companies.

**1.6** The BIS Business Survey takes data from the Labour Force Survey and HMRC data on PAYE and VAT registrations, eliminates double counting and indicates a population of sole proprietors and self-employed partners and companies comprising only an employee director totalling 4.0 million.<sup>4</sup> This includes around 650,000 companies with one employee.<sup>5</sup>

**1.7** In contrast, HMRC data<sup>6</sup> is based on all activities which an individual declares as part of the self-assessment process, covering a complete tax year. The latest information from this source (for the tax year 2012/13) gives 5.5 million individuals with income from self-employment sources. Of these, 3.5 million individuals pay tax on their income. To give this some context there are 23.4 million individuals in receipt of employment income who pay tax. These figures exclude those who are self-employed but who operate through a personal service company.

**1.8** Clearly then the number of individuals to be categorised as employed or self-employed is considerable, but this number alone is not a measure of difficulties associated with determining

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<sup>2</sup> <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/january-2015/statistical-bulletin.html#tab-1-->. Labour Force Survey data is collected over a period of time. References are to the period September to November 2014.

<sup>3</sup> <http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/january-2015/statistical-bulletin.html#tab-3-->

<sup>4</sup> BIS Business Population Estimates for the UK and Regions 2014 <https://www.gov.uk/government/statistics/business-population-estimates-2014>

<sup>5</sup> BIS Business Population Estimates, as above, Methodology & Quality Note, para 24.

<sup>6</sup> HMRC Personal Income Statistics 2012-13 <https://www.gov.uk/government/collections/personal-incomes-statistics>

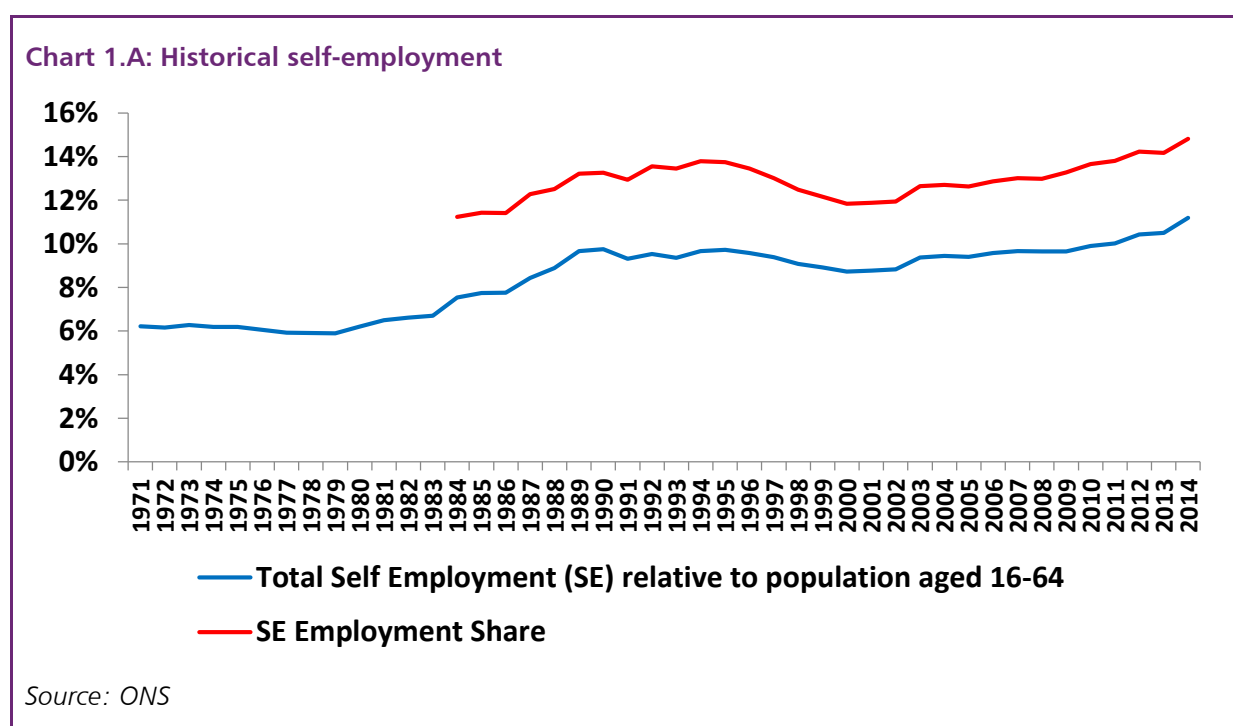
employment status. Similarly, increased numbers of self-employed do not necessarily mean increased tension on the self-employment/employment border.

## Changes in self-employment vs employment

1.9 Chart 1.A below illustrates long-term changes in the labour market, based on Labour Force Survey data. In terms of the overall labour force, since the 1970s the trend has been for a long term increase in the relative number of self-employed people, but sizeable shifts both ways earlier in the period suggest that to some extent what has happened latterly is the recovery of an earlier position. Viewing the chart but with start dates of 2004, 1994, or 1984 encourages contrasting narratives of changing patterns of employment and recent changes (and perhaps forecasts of future patterns) should be regarded with this in mind.

1.10 The definitions used are as follows:

- SE rate: self-employment relative to population aged 16-64
- SE employment share: self-employment as a share of total employment



1.11 There has been a long term **structural** shift to self-employment, which predates the recession; however, the characteristics of the self-employed mirrors changes in the labour force as a whole: in better educated and service sectors. The causes of the shift to self-employment have been discussed by many commentators<sup>7</sup>, who point to various factors including fewer people leaving self-employment (D'Arcy and Gardiner suggest that almost 30% of the growth in self-employment is for this reason) and an ageing population (so that self-employment can be seen as an alternative to retirement rather than alternative to being an employee: one-third of

<sup>7</sup> See for example: Office for National Statistics, 'Self-employed workers in the UK: 2014'

[http://www.ons.gov.uk/ons/dcp171776\\_374941.pdf](http://www.ons.gov.uk/ons/dcp171776_374941.pdf) : Conor D'Arcy and Laura Gardiner, "Just the job – or a working compromise? The changing nature of self-employment in the UK" Resolution Foundation May 2014 <http://www.resolutionfoundation.org/publications/just-the-job-or-a-working-compromise-the-changing-nature-of-self-employment/>; Andrew Burke. The Role of Freelancers in the 21<sup>st</sup> Century British Economy. <http://www.som.cranfield.ac.uk/som/dinamic-content/media/Vendy%20Lewis/Research/Andrew%20Burke,%20The%20Role%20of%20Freelancers%20in%20the%2021st%20Century%20British%20Economy,%20PCG%20REPORT.pdf>

the part time self-employed are over 60). In some industries there may be particular factors contributing to the structural shift, for example changes in public funding in administration and health (see below for industry patterns).

**1.12 Cyclical** factors in the changes include a faster shift to part-time work than amongst employees and a movement from being unemployed. Arguably these people may have pursued self-employment opportunities due to a lack of employment alternatives.<sup>8</sup>

**1.13** Broad changes in the composition of employment are shown in Table 1.A below:

**Table 1.A: Employment Growth – Changes relative to previous quarter in thousands**

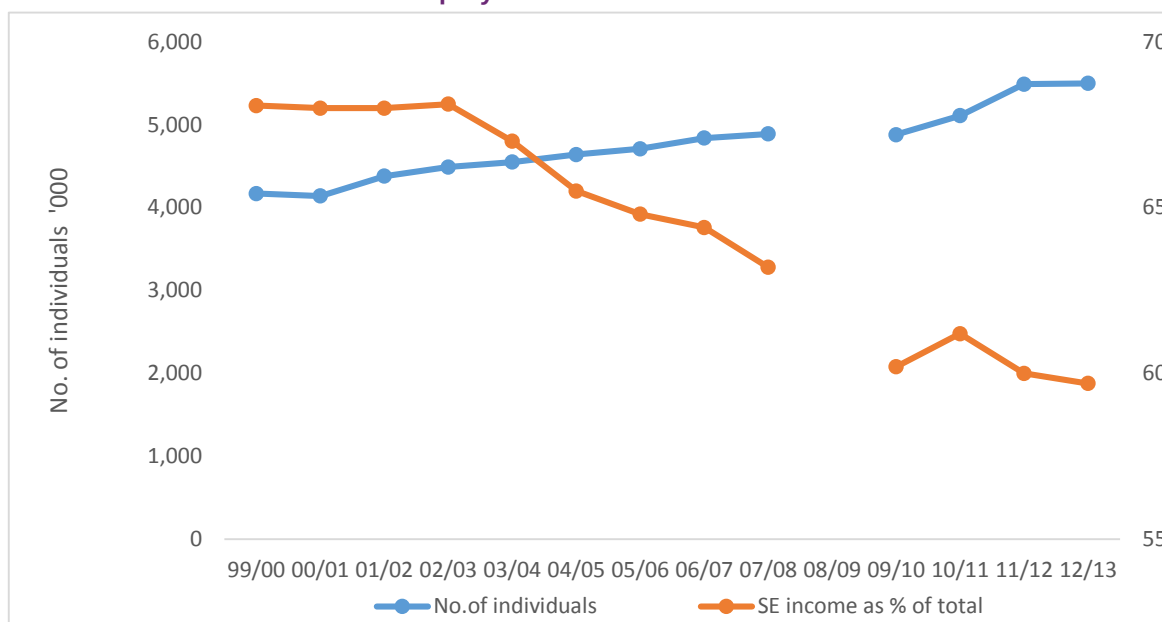
	Averages				2014	
	2000-07	2010-12	2013	2014-H1	Q3	Q4(a)
Employment Growth	70	67	95	196	113	38
- Of which, employees	55	33	62	102	196	80
- Of which, self-employed and others	16	35	33	94	-83	-42
a) Three months to November 2014						
b) Other comprises unpaid family workers and those on government-supported training and employment classified as being in employment						
Source: Bank of England Inflation Report, February 2015						

**1.14** The increase in self-employment reported in the Labour Force Survey is reflected in the number of individuals reporting income from self-employment sources in their self-assessment tax returns, the number rising from 4.2 million in 1999/00 to 5.5 million in 2011/12 and remaining static the following year. During this period self-employment income as a proportion of the total income of the self-employed fell from 68% to 60%, as more individuals combined self-employment with other income earning activities.(see Chart 1.B below)

<sup>8</sup> D'Arcy and Connor, 2014, and also Office for Budget Responsibility, Fiscal Sustainability Report 2014. <http://budgetresponsibility.org.uk/fiscal-sustainability-report-july-2014/>



**Chart 1.B: Individuals with self-employment sources of income**



Source: OTS, from HMRC Personal Income Statistics 1999/2000 to 2012/13. 2007/08 data not available

**1.15** Over this period as a whole the number of individuals declaring employment and/or pension income in addition to self-employment income has increased at a faster rate than the absolute increase in numbers of self-employed. However, the number declaring other income in addition to self-employment income has fallen both absolutely and as a proportion of the total, see Table 1.B.

**Table 1.B: Number of self-employed individuals declaring other income**

	1999/00		2012/13		% increase/(decrease)
	Number	%	Number	%	
<b>Total self-employed</b>	4,170,000	100	5,500,000	100	32
<b>With employment income</b>	1,190,000	29	1,770,000	32	49
<b>With pension income</b>	621,000	15	916,000	17	48
<b>With investment income, i.e. property, interest, dividends</b>	2,630,000	63	1,920,000	35	(27)

Source: HMRC Personal Income Statistics

## Changing characteristics of the self-employed population

**1.16** The self-employed population is diverse. In a sense the common feature is simply 'labour services not provided as an employee' as the term covers a huge range of economic roles from a self-directing, business-focussed entrepreneur (perhaps with employees) to an individual entirely subject to the whim of others.

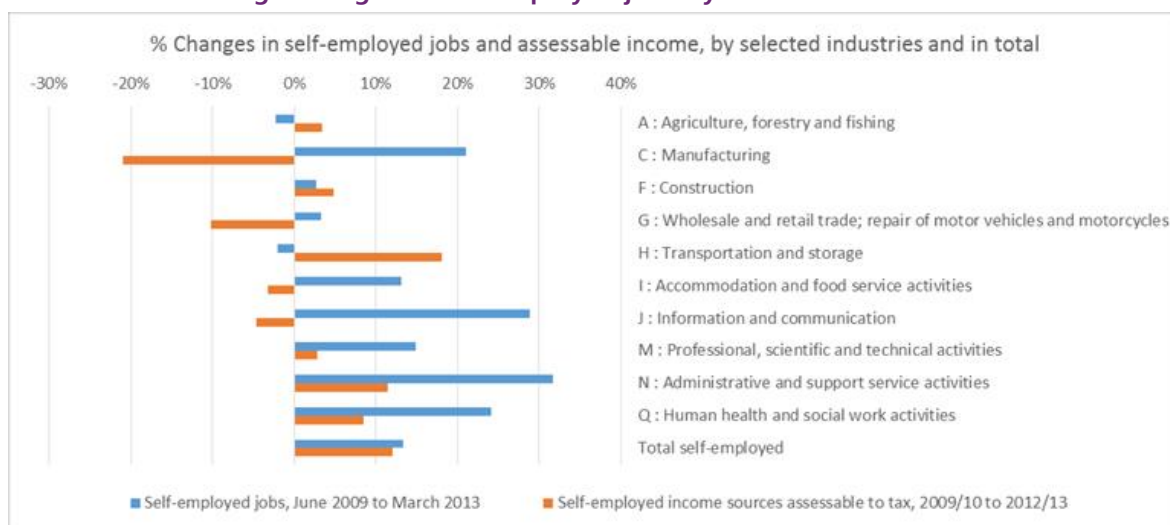
**1.17** Some particular features of the self-employed population and their changing characteristics include:

- knowledge intensive industries have had the greatest percentage increase in self-employment – but this sector also had the greatest increases in employment
- an increase<sup>9</sup> in
  - one-person businesses
  - part-time businesses
  - those combining employment with self-employment
  - women
  - people aged over 55

**1.18** But there is consistency in those entering self-employment (ie new starters as a percentage of self-employed), with an industry profile similar pre- and post- recession, and also for occupations, though some increases in professional occupations and decreases in skilled trades. Self-employed earnings are both lower and more unequally distributed than employee earnings.<sup>10</sup>

**1.19** Chart 1.C below shows (over a 4 year period) changing patterns of self-employment within selected industry sectors from the Labour Force Survey, and also changes in industry sectors reflected in the self-employment pages of self-assessment tax returns<sup>11</sup>. The data is not directly comparable as the tax data includes all sources of income (and one person may have more than one source) within a whole tax year, while the jobs data is based on individuals' views of their 'main employment' in a three month snapshot.

**Chart 1.C: Percentage changes in self-employed jobs by selected industries and in total**



Source: OTS analysis of data from the Office of National Statistics and HMRC data from Personal Income Statistics

**1.20** While the percentage change in the total number of self-employed is similar there are stark differences in the growth or shrinkage shown in particular industry sectors. In part this is likely to be because the industry classifications in the tax data are not as comprehensive as in the Labour

<sup>9</sup> D'Arcy and Connor, 2014

<sup>10</sup> Institute for Fiscal Studies, The IFS Green budget, February 2015, <http://www.ifs.org.uk/publications/7530>

<sup>11</sup> OTS, from Workforce Jobs – ONS, and HMRC Personal Income Statistics, 2009/10 and 2012/13, both series use SIC 2007 industry classifications. HMRC industry sector figures are based on all sources of self-employment income so an individual with more than one source is counted more than once. In consequence the total number of sources, 5.8 million, is greater than the total number of individuals declaring self-employment income mentioned earlier, 5.5 million.

Force Survey data. In the tax data a significant and increasing portion are indicated as 'unknown industries': by 2012/13 over 600,000 sources of self-employment income (11% of the total self-employed) were in this category. In contrast the interview basis for the Labour Force Survey enables everyone to be allocated to a specific industry. The notes accompanying the self-employment pages of the self-assessment tax return provide no guidance whatsoever on completion of the 'description of business' box in the tax return. Better information on the tax returns would enable HMRC to track and respond to changes in employment patterns.

**1.21** With this caveat on the comparability of the data, both series do illustrate the dynamic nature of the self-employment environment in recent years. Table 1.C shows the number of self-employed in all industry categories in March 2013, i.e. at the end of the period shown in Chart 1.C. Individuals within the largest industry category, construction, are likely to be within the Construction Industry Scheme, which is outside the scope of this report.

**Table 1.C: Self-employed by industry sector**

Industry sector	Number of self-employed	Total as % of total self-employed	Total as % of industry workforce
A : Agriculture, forestry and fishing	172,000	4.1	46.6
B : Mining and quarrying	7,000	0.2	9.7
C : Manufacturing	207,000	4.9	8.1
D : Electricity, gas, steam and air conditioning supply	7,000	0.2	5.5
E : Water supply; sewerage, waste management and remediation activities	9,000	0.2	4.6
F : Construction	798,000	19.1	39.2
G : Wholesale and retail trade; repair of motor vehicles and motorcycles	382,000	9.1	7.9
H : Transportation and storage	240,000	5.7	16.1
I : Accommodation and food service activities	146,000	3.5	7.4
J : Information and communication	192,000	4.6	15.2
K : Financial and insurance activities	66,000	1.6	5.8
L : Real estate activities	62,000	1.5	12.3
M : Professional, scientific and technical activities	487,000	11.6	18.9
N : Administrative and support service activities	295,000	7.1	11.5
O : Public administration and defence	39,000	0.9	2.5
P : Education	234,000	5.6	8.4
Q : Human health and social work activities	335,000	8	8.1
R : Arts, entertainment and recreation	218,000	5.2	24.4
S : Other service activities	254,000	6.1	31.6
T : Activities of households as employers; undifferentiated goods-and services-producing activities of households for own use	35,000	0.8	46.1
<b>Total</b>	<b>4,186,000</b>	<b>100.0</b>	<b>13.1</b>

*Source: OTS analysis of data from the Office of National Statistics*

## Categorisation within self-employments:

1.22 A further feature of the changing employment market is the introduction of new labels. These have no agreed definition and may cover many diverse groups. For example:

- the self-employed have been categorised into tribes<sup>12</sup> (visionaries, locals, classicals, survivors, independents, dabblers)
- some categorisations involve an implicit, or sometimes explicit, distinction between manual and intellectual labour
- freelancers have been identified, but in various ways:
  - professional self-employed from the highest three standard occupational classification codes, without employees<sup>13</sup>
  - a binary subset of the self-employed: entrepreneur or freelancer (with the employed similarly divided into executives or employees)<sup>14</sup>

1.23 Without a consistency in understanding and without a counting mechanism the significance of these groups (in the context of the issue of status uncertainty) is difficult to establish.

## Future changes in self-employment

1.24 The increase in self-employment appears to be part of a longer running structural trend, but there is evidence of a cyclical increase that may be fuelled by disguised unemployment. If some of these individuals were under employed, and so represented potential capacity in the labour market, then they could be absorbed into the employee workforce as demand continues to recover. While there may be some additional spare capacity and a reduction in the share of self-employment as the recovery gains strength, in the longer term commentators consider we are likely to see further increases in the share of self-employment. For example:

- The future scenarios painted by the UK Commission for Employment and Skills<sup>15</sup> build on a 'forced flexibility' scenario where: 'Employers offer premiums and incentives for high-skilled talent and top employees. In-house efficiency monitoring systems are frequently used to collect data to allocate required skills to work tasks. Market volatility drives increased flexibility in work arrangements, and temporary or zero hour employment contracts are the rule in many organisations.' The scenarios all imply an increase in flexibility and for workers more portfolio working and or project based work, suggesting a further trend towards self-employment.
- The Office for Budget Responsibility points out that as a larger proportion of older age groups tend to be self-employed, an aging population will lead to an increase in the proportion of the employed labour force who are self-employed.<sup>16</sup>

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<sup>12</sup> Royal Society of Arts, Salvation in a start-up? The origins and nature of the self-employment boom. <https://www.thersa.org/discover/publications-and-articles/reports/salvation-in-a-start-up/>

<sup>13</sup> John Kiching and David Smallbone Exploring the UK Freelance workforce, 2011, <https://www.ipse.co.uk/research/freelance-sector-research>

<sup>14</sup> Andrew Burke, The economic role of freelance workers in the construction industry, 2<sup>nd</sup> Ed <http://www.som.cranfield.ac.uk/som/dinamic-content/media/Wendy%20Lewis/Research/Freelance%20Workers%20in%20Construction%202nd%20Edition.pdf>

<sup>15</sup> The Future of Work: Jobs and Skills in 2030 <https://www.gov.uk/government/publications/jobs-and-skills-in-2030>

<sup>16</sup> Office for Budget Responsibility, Fiscal Sustainability Report 2014. <http://budgetresponsibility.org.uk/fiscal-sustainability-report-july-2014/>

- Growth in new forms of employment (eg micro jobs) via new intermediaries (eg internet based crowdsourcing platforms).<sup>17</sup>

## Drivers for employment vs self-employment

**1.25** Within the broader economic environment individuals and hirers make individual decisions on the form of engagement.

**1.26** The provision of labour services involves a direct or indirect bargain between an individual and a hirer. The vast majority of individuals provide their labour services directly as employees. Individuals have reasons why they may prefer self-employment or employment and engagers also have reasons to favour one form over the other. The main drivers explained to us are listed below in Table 1.D for individuals and in Table 1.E for engagers, and explored further in Chapter 6, Managing in practice. Some are positive (seeking an outcome) and some are negative (avoiding an outcome). The actual weighting applied to the various factors will vary according to the relative bargaining power of engager/individual and to industry norms. Drivers with a fiscal tinge are shown in italics.

**Table 1.D: Drivers for self-employment: individuals and personal service companies**

		Individual	Personal service company
Positive factors	Flexibility – duration & location	Y	Y
	Flexibility - experience	Y	Y
	Limited personal liability		Y
	<i>Lower NICs<sup>18</sup></i>	Y	Y
	<i>Access NICs employment allowance</i>		Y
	<i>Take home pay</i>	Y	Y
	<i>Income received as dividends and/or income sharing leading to lower income tax</i>		Y
	<i>Access to Working Tax Credit rather than Jobseekers' Allowance</i>	Y	
	<i>Favourable travel and subsistence rules</i>	Y	Y
	<i>Tax not deducted at source, so delayed tax payment</i>	Y	Y
	<i>Potential for deductible expenses</i>	Y	Y
	<i>VAT flat rate scheme</i>		Y
Negative factors	Engager compels individual to work as self-employed (or to provide services through an agency)	Y	Y
	Employment not available	Y	Y
	<i>Potential for tax evasion</i>	Y	Y

Source: OTS analysis

<sup>17</sup> See for example "Crowd employment platforms: the case of Amazon Mechanical Turk" Debra Hourcroft and Birgitta Bergvall-Kåreborn, FairWRC research briefing no. 6, The University of Manchester Business School, <http://www.mbs.ac.uk/assets/pdf/researchbriefingsNo6/issue1/index.html>

<sup>18</sup> On a macro level the cost of this differing treatment has been estimated by HMRC as £2.65bn. (HMRC Estimated costs of tax reliefs, expenditure and allowances 31/12/14: Reduced contributions for self-employed not attributable to reduced pensions eligibility. The explanatory note says "Represents the difference between class 2 and 4 NICs paid by the self-employed on their profits and an estimate of the class 1 NICs that would be paid at contracted out rates on an equivalent amount of employee earnings. The class 1 estimate includes employer contributions due but assumes a corresponding reduction in earnings to hold staff costs broadly constant, and also takes account of the resulting reduction in income tax.")

**Table 1.E: Drivers for self-employment: engagers**

		Individual	Personal service company
Positive factors	Off headcount, including recycling from employment	Y	Y
	Numerical flexibility	Y	Y
	Term flexibility	Y	Y
	<ul style="list-style-type: none"> <li>• specific skills</li> <li>• trial engagement before permanent employment</li> </ul>		
	Lower whole life engagement costs <sup>19</sup>	Y	Y
	Covering absence of permanent staff	Y	Y
	<i>No class 1 NICs</i>	Y	Y
Negative factors	Employment rights management		Y
	National Minimum Wage avoidance		Y
	Workers only available as self-employed	Y	Y
	<i>Lower compliance risk</i>		Y

*Source: OTS analysis*

**1.27** As can be seen, there are many drivers towards self-employment and working through personal service companies. In contrast, the drivers towards employment are far fewer:

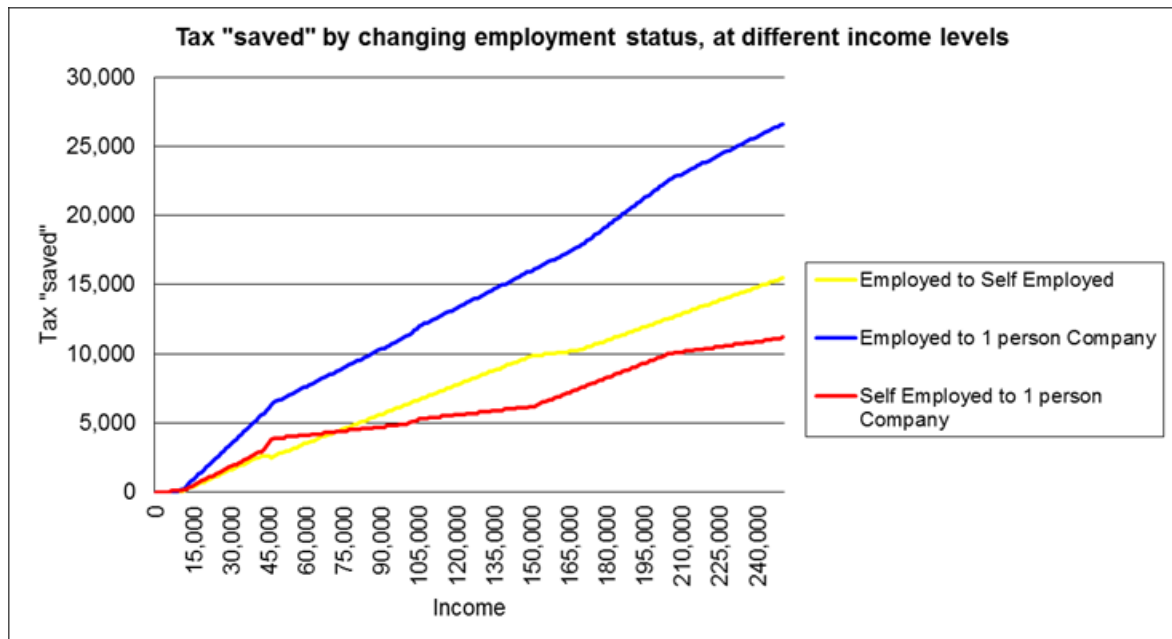
- Individual: security - employment rights, employee benefits
- Engager: security - employee commitment, lower compliance risk

**1.28** There are perhaps some broad themes: the changing expectations and aspirations of individuals, skills shortages affecting bargaining power and cost pressures. Engagers have an overriding drive to manage risk as they desire certainty on potential costs, including the gamut of employment rights as well as tax costs. Those tax costs include PAYE/NICs, penalties (both corporate & Senior Accounting Officer), and reputation.

**1.29** In relation to individual engagements the tax factors mentioned above translate into sizeable differences in the combined tax and national insurance burden. This is discussed in Chapter 10. At different income levels the impact is shown in Chart 1.D below. The tax saving mechanism in part reduces the tax paid by the engager and in part the tax paid by the individual, though the 'wage-pot' approach to the calculations reflected in the chart assumes that the engager's saving is passed on to the individual.

<sup>19</sup> Including hire fees, ongoing pay and benefits, pension (and auto-enrolment), payroll set up and on-going administration, performance management, redundancy, holiday, sick pay, maternity pay.

**Chart 1.D: Tax and NICs 'saved' by changing employment status, at different income levels**





Source: HMRC analysis provided to OTS. All figures on a 'wage-pot' basis, i.e. the engager pays constant sum regardless of the engaging mechanism. One person company assumed to pay salary equal to personal allowance and the remainder as dividend.











## Border raids

**1.30** While the underlying determinants of employment status for tax have remained unchanged (though constantly re-scrutinised as case law has developed) the regulatory framework for tax has altered as changes have taken place in the engagement structures used in the labour market. In part these shifts (whether in tax law or in labour market practices) have been attempts to locate individuals for tax purposes on different sides of the employed/self-employed divide.

**1.31** Some of the movements are shown in Table 1.F below (the table does not attempt to be a comprehensive history of the many changes in this area), illustrating the fluid regulatory and market environment. The existence of distinct tax rules in different engaging situations (even before considering the practices associated with particular occupations – see Chapter 3) is part of the complex tax environment which individuals and engagers must understand in order to fulfil their tax obligations.

**Table 1.F: Market and tax environment movements affecting employment status**

Regulatory changes causing new reporting obligations and/or increased tax liabilities, akin to employment tax consequences	
Changing market practices, in part to reduce reporting obligations and/or reduce tax liabilities, akin to self-employment	

Employment or quasi - employment tax consequences	Self-employment tax consequences	Market/tax environment change
		Construction Industry Scheme withholding requirements
		1988 agency rules placed recruitment companies at risk of PAYE
		Use Personal Service Companies to place the risk with the directors and away from agencies; also to reduce tax (for other drivers see above). Initially the high paid market
		1999 IR35 treats Personal Service Company owner/worker as deemed employee in some circumstances
		Use umbrella companies (leading later to concerns of forced self-employment), also composite companies
		2007 managed service company rules
		Use offshore intermediaries (eg supply teachers hired through Sark)
		Use personal service companies for low paid
		Offshore employment intermediaries rules
		Use of agency contracting structures to assist self-employed categorisation
		Onshore intermediaries rules extend circumstances when PAYE must be applied

## The price of uncertainty

**1.32** Uncertainty in establishing status is difficult to measure but overwhelmingly those responding to our online survey consider that uncertainty exists, see Annex C, and this was reflected too in discussions with interested individuals, see Chapter 6: Managing in practice. Complexity, whether actual or perceived, creates uncertainty and generates costs for all parties:

- For engagers, intermediaries and individuals –



- the administrative cost of determining the correct attribution
- the cost of establishing and running structures to limit risk (but these of course are also in themselves an economic activity)
- the cost in the form of unexpected tax liabilities and penalties of making judgments subsequently found to be incorrect
- For the Exchequer – tax lost through misattribution
- For HMRC – the cost of ensuring and encouraging compliance.

**1.33** The scale of these costs is not known. Some sketchy information provides hints:

## Costs for engagers, intermediaries and individuals

**1.34** KPMG reviewed the costs of compliance for businesses in 2006, using 2002 data, and the costs covering PAYE/NICs issues are set out in Table 1.G below. The element within the first two categories due to employment status issues is not known.

**Table 1.G: Compliance burdens for businesses**

Compliance obligation	Compliance burden
Cooperating with audits / Inspection of PAYE records	£25 million
Inspection of employers NICs records	£25 million
Seeking HMRC guidance on employment status	£ 1 million
<i>Source: KPMG administrative burdens HMRC measurement project, 2006</i>	

**1.35** These figures ignore the costs for engagers of exercising judgements (in human resources, procurement, legal and tax functions) and do not include the costs of risk-mitigating structures.

## Tax lost through misattribution

**1.36** HMRC publishes an estimate for the ‘tax gap’ (the loss of tax/NICs due to error, evasion and avoidance) for employers, see Table 1.H below.

**Table 1.H: HMRC tax gap figures for employers**

	2005/06	2011/12
Proportion of SME employers failing to meet fully their PAYE obligations	41%	23%
SME employers’ tax gap	£0.6 bn	£0.2 bn
Large employers’ tax gap	£1.7 bn	£1.5 bn
<i>Source: HMRC Measuring Tax Gaps 2014 Edition, Tables 6.7, 6.8, 6.9. Gap shown above is ‘Incorrect returns’ mid-point estimate less compliance yield</i>		

**1.37** These figures cover a large range of PAYE obligations. HMRC does not publish how much of the tax gap is due to status issues and false self-employment, but there are some clues to the impact of the issue.

**1.38** Using HMRC's published data, a starting position for the tax lost could be calculated as follows. The total number of tax-paying self-employed people in 2012/13 was 3,490,000 according to HMRC's personal income statistics. The same data gives the mean self-employment income as £21,000. The OTS has calculated that if self-employment income of £21,000 is re-categorised as employment income an additional £900 tax and NICs is payable.

**1.39** Taking these assumptions, it is possible to crudely estimate tax gaps for different scenarios of which percentage of the self-employed population should be re-categorised as employed. This is done by multiplying different percentages of the total self-employed population by the additional tax and NICs payable for the mean self-employment income, see Table 1.1:

**Table 1.1: Calculation of tax gap for employment status, different scenarios**

Estimated % of self-employed taxpayers who should be categorised as employed	10%	5%	3%	1%
Estimate of total tax/NICs underpaid	£314m	£157m	£94m	£31m
<i>Source: OTS analysis of HMRC data</i>				

**1.40** By way of comparison:

- HMRC estimates that the existence of IR35 protects revenues of £550m.<sup>20</sup>
- A recent government consultation estimated that one type of false self-employment had resulted in 200,000 people in the construction sector and 50,000 others being wrongly designated as self-employed (though no longer, following legislation).<sup>21</sup>

## HMRC Compliance costs

**1.41** We do not have information on HMRC's costs relating to employment status issues. These will include staff costs, the cost of litigation and other operating costs such as developing and running the Employment Status Indicator.

## Conclusion

**1.42** Increases in the total number of self-employed and changes in particular industries are evident in information from various sources. These changes may continue in the future. While the absolute number of self-employed is not necessarily a direct measure of the overall burden caused by the need to establish an employment tax status (as this may be easier in some growing sectors than in others – see Chapter 6 Managing in Practice), a very significant proportion of the population has to consider the tax distinction between employment and self-employment in relation to their own tax affairs and almost all businesses have to do so.

**1.43** Changing patterns of employment (for example multiple and sequential contracts of varying periods of time and with one or many engagers, and perhaps contemporaneous with activity which is clearly employment) mean that this is not a once off challenge at the outset of a career but something which may need to be addressed on multiple occasions in a working life.

<sup>20</sup> House of Lords Select Committee on Personal Service Companies: The Government's Response, June 2014,

<http://www.parliament.uk/documents/lords-committees/Personal-Service-Companies/Personal-Service-Companies-Government-Response.pdf>

<sup>21</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/264649/Onshore\\_employment\\_intermediaries\\_-\\_false\\_self\\_employment.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264649/Onshore_employment_intermediaries_-_false_self_employment.pdf)

As more people move to an economic environment where they receive a retirement pension plus self-employment income these issues may face some for the first time later in life, after being accustomed to the simplicity of unambiguous employment.

**1.44** Though little information is available on the administrative costs, whether of individuals, businesses or HMRC, the scale of the tax consequences of attributing the wrong status is clear and is an inevitable cause of compliance anxiety and perhaps of tax-induced behaviour.

## 2 Legal background

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### What is employment status?

**2.1** Employment status is the status of an individual for the purposes of tax or employment law, i.e. whether they are employed or self-employed. For tax purposes it might just as well be called 'tax status', but it has become known as employment status. Employment status is established ultimately by case law but, on an everyday basis, it is up to the business or individual to figure out whether they are employed or self-employed.

**2.2** At present there is no synergy between tax and employment legislation where status is concerned. The fact that an individual is an employed earner for Class 1 NICs and pays PAYE does not give them employment rights, although it does give them 'benefits'. Employment rights are gained through having a contract of employment and in some cases 24 months' continuous service.

**2.3** There are various cases<sup>22</sup> where an individual is employed for NICs purposes but self-employed for income tax and isn't entitled to any employment rights. There are also cases where an individual is considered a limb b worker for employment rights, but is taxed as a self-employed person.<sup>23</sup>

### Definition of self-employment

**2.4** There are a myriad of descriptions for the self-employed including freelancer, sole trader, contractor, sub-contractor, consultant, etc. but there is no statutory definition<sup>24</sup>. These many labels, which have no statutory basis, only serve to create further confusion and to add to the complexity.

**2.5** The terms 'contract for services' or 'contract of service' are used to describe the different contracts. A contract 'for' services is a commercial contract for the services of a self-employed individual, whereas a contract 'of' service is akin to a contract of employment. To avoid confusion in this report, a contract of employment will be referred to in preference to a contract of service and, as the term 'worker' can be misconstrued, the term 'individual' will be used.

**2.6** Additionally, the terms contractor, sub-contractor, freelancer, consultant, etc., may also refer to those who provide their services through a limited company which is sometimes called a Personal Service Company.<sup>25</sup> There are, however, different rules for an individual who provides their services through a limited company and these rules are known, colloquially, as IR35<sup>26</sup>.

**2.7** In 2010, the OTS carried out a review of IR35 and as a result the HMRC IR35 Forum was set up. The IR35 Forum has just released its final report<sup>27</sup> and as a result of this IR35 has been excluded from this OTS review. However, whether an individual who provides their services through a limited company is a 'deemed' employee or not for tax purposes under IR35 is established by the same employment status case law. So, in that sense, the OTS are conscious

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<sup>22</sup> See Chapter 3 - Particular occupations

<sup>23</sup> For example those individuals on zero hours contracts, if the contract has no 'mutuality of obligation'.

<sup>24</sup> Other than for a "self-employed earner" under section 2(1)(b) Social Security Contributions and Benefits Act 1992. However this definition is not helpful for the current discussion.

<sup>25</sup> A personal service company or PSC is a label given to an ordinary incorporated company that typically has a sole director and majority shareholder, where the director and individual who provides the services are one and the same. The label 'personal service company' has no basis in law.

<sup>26</sup> Chapter 8 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003 and in the statutory instrument Social Security Contributions (Intermediaries) Regulations 2000, SI 2000/727

<sup>27</sup> IR35 Forum Administration Review Final Report – 5 January 2015 (<https://www.gov.uk/government/publications/ir35-forum-administration-review-final-report>)

that personal service companies may be affected by any outcomes from this review, if taken forward by the government.

**2.8** When referring to the ‘self-employed’ in this Chapter, therefore, the reference will be to those who are not providing their services through a personal service company and may or may not be registered with HMRC and have a Unique Taxpayer Reference number.

## Definitions of employee and worker

**2.9** Although there is no statutory definition of ‘self-employment’ or the ‘self-employed’, there is a statutory definition for ‘employee’<sup>28</sup> and ‘worker’ under employment legislation. In employment law, a third category is recognised for status purposes, that of the ‘worker’, sometimes known as the ‘limb b worker’, named after the section of legislation it resides in, see Box 2.A below.

### Box 2.A: Definition of ‘worker’ in section 230(3) Employment Rights Act 1996

- (3) In this Act “worker” ... means an individual who has entered into or works under (or, where the employment has ceased, worked under)—
- (a) a contract of employment, or
  - (b) any other contract, whether express or implied and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual;

**2.10** This adds to the complexity because the ‘worker’ category is not recognised in tax law. For tax purposes an individual is either paying taxes as an employed person or as a self-employed person. The difficulty with the third status under employment law is that although the limb b worker has basic employment rights, they may still be taxed as a self-employed individual. The Department for Business, Innovation and Skills (BIS) has recently announced<sup>29</sup> that it will be conducting a review of employment status from an employment rights point of view and, as such, the OTS will only be considering the limb b worker as it applies to tax rather than employment law.

## Is self-employment a choice?

**2.11** The cost of misclassification of an individual’s status for either tax or employment rights purposes is huge, as detailed in the last Chapter. Equally, the cost of compliance in trying to assess an individual’s status, can be a burden on business. Not only is it a financial burden but it also gives a competitive advantage to those companies that deliberately misclassify their workforce<sup>30</sup>.

<sup>28</sup> See Annex D – Employment status legislation and case law

<sup>29</sup> <https://www.gov.uk/government/news/employment-review-launched-to-improve-clarity-and-status-of-british-workforce>

<sup>30</sup> Hatfield I (2015) Self-employment in Europe, Institute for Public Policy Research. (<http://www.ippr.org/publications/self-employment-in-europe>)

**2.12** Many of the cases that reach court concern the interpretation of the contractual terms and the manipulation of the relationship through the contract to avoid the employer/employee relationship. But as was stated in an Australian case:

**Box 2.B: Quote from an Australian employment status case:**

*"...the parties cannot create something which has every feature of a rooster, but call it a duck and insist that everybody else recognise it as a duck."*<sup>a</sup>

a Gray J in *Re Porter: ex parte Transport Workers Union of Australia* (1989) 34 IR 179 at 184

**2.13** Creative accounting and "armies of lawyers"<sup>31</sup> drafting divisive legal documents may disguise employment, but closing these loopholes is also a pressure on the government.

**2.14** There appears to be a general perception, as reported by interested parties to the OTS, that the classification of an individual's status for either tax or employment rights purposes is a choice. This perception is mainly held by individuals rather than businesses, but evidence<sup>32</sup> shows that some businesses will offer a choice of whether to contract as a self-employed worker with a tax free rate, as opposed to being offered employment. Equally, there are businesses that genuinely believe the arrangement is not an employment relationship and classify the individual as self-employed simply because the work is not permanent, but the classification of an individual's employment status does not rely on the permanency of the position.

**2.15** Employment status is not, however, a choice. It is a mixed question of fact and law that ultimately is for the courts to decide upon. In the absence of court action, however, businesses and individuals are expected to decide upon the 'correct' employment status themselves. This incurs time and cost, and is a continual process, because if the facts change, the status may change too. Businesses may consult their accountant or lawyer, which again increases the cost of the decision, but the penalties for getting the decision wrong are not just punitive, they can also affect the reputation of a business.

## Determined by case law

**2.16** In order to determine employment status, it is necessary to refer to the tests and factors found in case law and the body of case law that contains the tests and factors goes back many years. Over the years, various tests have been proposed and many factors considered, but despite many attempts by the judiciary, there is no one single test.

**2.17** Employment status is a complex area of law, so complex that it has taken a recent case<sup>33</sup> five years and two visits to the Court of Appeal. The case concerned whether a company director was an employee or a worker or neither for employment rights purposes. What was notable about this case is that the claimant, Mr Stack, had first lodged a claim in April 2010 and the preliminary issue for the Employment Tribunal was to determine his status. The Employment Tribunal judge held that he fell into neither employee nor worker status, the case then progressed to the Employment Appeal Tribunal who concluded that the Employment Tribunal judge had made an error in law in his approach and remitted the case back to a different tribunal. After this point, the case eventually ended up in an appeal to the Court of Appeal, for the first time.

<sup>31</sup> *Consistent Group Ltd v Kalwark* [2008] EWCA Civ 430 at para 57-59 Elias J in the EAT.

<sup>32</sup> Clark T (2014b) 'Unwilling freelancers give the lie to unemployment statistics', Guardian, 28 October 2014.

<sup>33</sup> *Stack v Ajar-Tec Ltd* [2015] EWCA Civ 46

**2.18** The appeal by the company in the Court of Appeal was dismissed and sent back to another tribunal. After a four day hearing, the new Employment Tribunal delivered its judgment in January 2013, nearly three years after the first tribunal, the judgment being that Mr Stack was both an employee and a worker.

**2.19** The company then appealed to the Employment Appeal Tribunal and in a judgment on 30 May 2014, the judge decided that the second tribunal had made an error in finding that there was a contract of employment and that Mr Stack was neither an employee nor a worker. For the second time the case was heard in the Court of Appeal nearly five years after the claim was first brought and the Court unanimously decided that Mr Stack was both an employee and a worker.

**2.20** In the opening line of the judgment in the Court of Appeal, Lord Justice Tomlinson commented that: *"This case is not a good advertisement for our system of resolving employment [status] disputes."* It is, however, a very good advertisement for why employment status needs simplifying.

**2.21** In another notable case<sup>34</sup> the Special Commissioner thought that the decision should be relatively straightforward since there were countless authorities on the subject. However, *"...notwithstanding this, [he] ... found it extremely difficult to reach [his] decision."* The tribunal judges have to make the first analysis of the facts and law on a case involving employment status and in this case the Commissioner thought there were: *"...six slightly different lines of authority designed to clarify the distinction between the status of employees and that of self-employed sub-contractors..."* The "material pointers" are set out in Box 2.C below:

**Box 2.C: Case law: six material pointers to clarifying employment status**

- The so-called 'mutuality of obligation' requirement, or 'touchstone'
- The famous and often quoted three tests set out by Mr Justice MacKenna in *Ready Mixed Concrete*<sup>35</sup>
- The 'substitution' point
- The authorities that concentrate on the issue of whether the worker is in business on his own account
- The intentions of the parties
- The approach based on balancing numerous pointers in each direction and standing back and looking at the overall picture

## Divided opinion

**2.22** The *Castle Construction* case above is notable also because in 2002 the Inland Revenue determined that the workers were indeed self-employed but, unaware of this, in 2006 HMRC gave another opinion that the workers were employed. In the event, the Special Commissioner disagreed with HMRC and decided the 321 workers were, in fact, self-employed. In yet another example,<sup>36</sup> HMRC had carried out an audit the conclusion of which was that the car valeters

<sup>34</sup> *Howard Nolan in Castle Construction (Chesterfield) Ltd v HMRC* (2009) UK SpC 00723

<sup>35</sup> *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497

<sup>36</sup> *Autoclenz Ltd v Belcher & Ors* [2011] UKSC 41

were likely to be self-employed for tax purposes. A number of years later the Supreme Court held that the car valeters were, in fact, working under a contract of employment.<sup>37</sup>

### Three tier test – Ready Mixed Concrete

**2.23** As mentioned above, the ‘famous’ case that is most often cited as a start point is the judgment of MacKenna J in *Ready Mixed Concrete*. This case hails from the late 1960s and proposed the following test:

#### Box 2.D: The Ready Mixed Concrete case – the three tests for employment

*“A contract of service exists if these three conditions are fulfilled.*

*(i) The servant agrees that, in consideration of a wage or other remuneration, he will provide his own work and skill in the performance of some service for his master.*

*(ii) He agrees, expressly or impliedly, that in the performance of that service he will be subject to the other’s control in a sufficient degree to make that other master.*

*(iii) The other provisions of the contract are consistent with its being a contract of service.”<sup>a</sup>*

<sup>a</sup> MacKenna J in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497

**2.24** This test, however, was to establish whether a contract of service exists, not whether someone is employed or self-employed as in the ‘in business test’ below or, in fact, to define what constitutes a contract for services.

**2.25** The first part of the test seems to refer to the “*want of mutuality requirement*”, but it seems that the point that MacKenna J was actually making was namely the obligation on the employee “*to provide his own work and skill*”, i.e. to provide personal service.

**2.26** The second point refers to the element of control which, it is argued in case law, is either “*vital*” or “*diminished in importance*” and one that can be quite difficult to apply. The various aspects of control are what make it difficult to apply, this is with reference to telling a worker what, when or where the work is to be done rather than how it is to be done. Telling a worker how something is to be done can be the crucial difference between having sufficient control or not.

**2.27** The third element of the test appears to state that one must quite sensibly look at the terms, or absence of terms, in order to judge whether they reinforce or undermine the initial conclusion.

**2.28** Even though the Ready Mixed Concrete test has been used time and time again, it is not without its complications, and it is also not the only ‘test’ that has been propounded. Another example is that of *Market Investigations*<sup>38</sup>, this case also hails from the late 1960s and gave us the ‘in business on your own account’ test. This test is widely used today in business and by government<sup>39</sup> asking the question “Are you in business on your own account?”

<sup>37</sup> The car valeters were found to be limb ‘a’ workers working under a contract of employment – similar to an employee.

<sup>38</sup> *Market Investigations Ltd v Minister of Social Security* [1969] 2 QB 173 Cooke J

<sup>39</sup> For example it is used by BIS in the Agency Workers Regulations Guidance May 2011



## In business on your own account – Market Investigations

**2.29** The ‘in business’ test asks the question “Are you in business on your own account?” which requires a ‘yes’ or ‘no’ answer. This assumes that the answer is either ‘no’ and that the contract is one of employment or ‘yes’ and that the contract is one for services. This precludes there being a third type of contract, for example a contract *sui generis*<sup>40</sup>. Interestingly, it was the same judge who proposed the ‘in business’ test a year before he proposed that there was a third type of contract *sui generis*. The test, however, has been largely discredited as being fundamentally flawed<sup>41</sup> but, despite this, it appears to continue to be used, less so in the courts but more as the basis for a statutory provision or a label to denote self-employment or being ‘in business’.

**2.30** The judge in that case went on to apparently contradict himself later in the same case by stating that a person may well be self-employed even though he has not entered into a contract in the course of an existing business carried on by him. The ‘in business’ test may also be inappropriate where the individual is in a profession or vocation and where the individual has many assignments which are all of short duration. So it seems wholly inappropriate to use the ‘in business’ test in many circumstances, especially when there are more appropriate tests that can be used.

### Factors

**2.31** It is fair to say that the MacKenna test in Ready Mixed Concrete and the ‘in business’ test in Market Investigations can be called ‘tests’, but it is debatable whether the other labels are called tests or factors<sup>42</sup>, although this is largely immaterial. What is certain is that they have to be considered, even if to be discounted. There are many ‘factors’<sup>43</sup>, but for the purposes of this report we will cover the most contentious, and those that were commented on. These are:

- mutuality of obligation;
- control;
- substitution;
- intention; and
- equipment.

**2.32** This wealth of factors that have to be considered, however, differs depending on the facts of the case. As was pointed out so eloquently in *Hall v Lorimer*:

#### Box 2.E: The correct approach to employment status case law

*“...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... 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.”<sup>a</sup>*

<sup>a</sup> *Hall (Inspector of Taxes) v Lorimer* [1994] ICR 218

<sup>40</sup> *Construction Industry Training Board v Labour Force Ltd* [1970] All ER 220 QBD Cooke J

<sup>41</sup> *Nethermere (St Neots) Ltd v Gardiner* [1984] ICR 612

<sup>42</sup> ESM 0500 covers the various factors in comprehensive detail.

<sup>43</sup> Other factors may include financial risk, economic reality, part and parcel of or integration into the organisation.

## Mutuality of obligation

**2.33** Mutuality of obligation<sup>44</sup> or the “*irreducible minimum of obligation*” are concepts that have evolved from a statement made in a case<sup>45</sup> in 1941. The test was then expanded in *Ready Mixed Concrete*<sup>46</sup>. The irreducible minimum of obligation was further expanded in *Nethermere*<sup>47</sup> in 1984 where Stephenson LJ stated that: “*There must ... be an irreducible minimum of obligation on each side to create a contract of service...*”. That statement in itself, however, then spawned more case law on whether the absence of mutuality of obligation was fatal to the existence of a contract of employment or merely just a powerful pointer.

**2.34** The problem with mutuality of obligation is that it may give a different result depending on whether it is used for tax or employment rights purposes. Mutuality of obligation is predominantly used in employment rights cases because the individual is seeking to establish that they can create a global contract from a series of short assignments in order to obtain the continuous services necessary to gain full employment rights, currently 24 months. For employment rights purposes, the court will look at the time when the individual wasn’t working between contracts and if there is no mutuality of obligation in this period the case will “...founder on the rock of absence of mutuality...”<sup>48</sup> It was stated in that case, however, that “...no issues arise as to their status when actually working [as guides].” Indeed, in its employment status manual<sup>49</sup> HMRC states that “*The case is **not** justification for claiming that people working on a “casual as required” basis cannot be employees.*”

**2.35** There is much argument as to what mutuality of obligation actually means. In its simplest form “...in consideration for a wage... he will provide his own work in the performance of some service...” could apply equally to a contract of employment or a contract for services. For there to be a binding contract of any kind, there must be “valuable consideration” given by both parties. It followed in *Nethermere*, that: “...there must... be an irreducible minimum of obligation on each side to create a contract of service. I doubt if it can be reduced any lower than in the sentences I have just quoted...”.

**2.36** It may be that mutuality of obligation means you have to provide your own work and skill for a wage, bringing in ‘personal service’, or that there has to be a continuing obligation outside of the contract as argued in *Prater*<sup>50</sup>, or that ‘pay’ is the key criterion, i.e. that the perceived employer has to pay regardless of whether there is any work. What is certain is that there is no consistent opinion.

## Control

**2.37** Control is another important factor; in the days of ‘master and servant’ it used to be critical but has diminished in importance over time. It is the second limb of the MacKenna test in *Ready Mixed Concrete* and HMRC devote fourteen sections of their employment status manual to this factor.<sup>51</sup>

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<sup>44</sup> ESM 0543 – Mutuality of Obligation

<sup>45</sup> *Stable J in Chadwick v Pioneer Private Telephone Co. Ltd.* [1941] 1 All E.R. 522, 523D: “A contract of service implies an obligation to serve, and it comprises some degree of control”

<sup>46</sup> By MacKenna J in *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497

<sup>47</sup> By Stephenson LJ in *Nethermere (St Neots) Ltd v Gardiner* [1984] ICR 612

<sup>48</sup> Lord Irvine LC in *Carmichael v National Power plc* [1999] UKHL 4 All ER 897.

<sup>49</sup> ESM 7200 - Case law: *Carmichael v National Power plc*

<sup>50</sup> *Cornwall County Council v Prater* [2006] EWCA Civ 102

<sup>51</sup> ESM 0516-0529

**2.38** A sufficient degree of control has to be exercised but control differs depending on the type of worker. Where the individual is highly skilled or expert, the engager may not be able to control 'how' the work is done, but may still be able to control what, where and when and this may tip the balance.

**2.39** In one case it was stated: *"When one is dealing with a professional man or a man of some particular skill and experience ... there can be no question of the employer telling him how to do the work; therefore the absence of control and direction in that sense can be of little, if any, use as a test."*<sup>52</sup>

**2.40** Having the right of control, even if the control hasn't been exercised is, in some cases<sup>53</sup>, sufficient to establish the control element. Supervision and direction have been added to the control element in more recent years as a result of legislative drafting.<sup>54</sup>

## Substitution

**2.41** Substitution is the flip side of personal service, if an individual provides a substitute, or if there is an unfettered right in the contract to provide a substitute, thereby having no obligation to perform the services personally, then there can be no contract of service.<sup>55</sup>

**2.42** HMRC place great importance on personal service/substitution, devoting ten sections in their employment status manual to this factor,<sup>56</sup> but again, there is no consistency in the approach. If there is a contractual right to substitute, which is a genuine reflection of the true agreement between the parties, then it will most likely be inconsistent with a contract of employment. There is a difference, however, between the right of substitution and the actual substitution in practice. For example, in one case<sup>57</sup> a substitute had been provided, but it was only when the worker was unable to provide the services and the worker didn't pay the substitute, the council did.

**2.43** Again we are hearing that substitution is a very difficult issue that is much misunderstood. One HR practitioner we spoke to had spent a lot of time and money on getting advice for the corporation on the substitution factor. The point being whether, if they wanted to hire an expert where a substitute would not be acceptable, the contract could not be a contract for services.

## Intention

**2.44** The intention of the parties is often overlooked but it can be a crucial piece of evidence, as can the actual contract between the parties. In one recent case<sup>58</sup> it was stated that *"...it is legitimate for the court to have regard to the way in which the parties have chosen to categorise their relationship. In cases where the position is uncertain, it can be decisive."*

**2.45** In another recent case<sup>59</sup>, however, it was held that the courts can disregard the contract if it doesn't reflect the reality of the working relationship. *"In the employment context the courts must be alive to the possibility that written documentation may not accurately reflect the reality of the relationship between the parties. Employers may include terms aimed at avoiding a particular statutory result, even where such terms do not reflect the real relationship."*

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<sup>52</sup> *Morren v Swinton & Pendlebury Borough Council* [1965] 2 All ER 349, at 351H

<sup>53</sup> *Talentcore Ltd (t/a Team Spirits) v HMRC* [2011] UKUT 423 (TCC)

<sup>54</sup> Discussed further below in Quasi statutory test and rules

<sup>55</sup> *Australian Mutual Provident Society v Chaplin* [1978] 18 ALR 385

<sup>56</sup> ESM 0530 - 0539

<sup>57</sup> (1) *MacFarlane* & (2) *Skivington v Glasgow City Council* [2000] EAT 1277/99

<sup>58</sup> *Stringfellow Restaurants Ltd v Quashie* [2013] IRLR 99 at para 52

<sup>59</sup> *Autoclenz Ltd v Belcher & Ors* [2011] UKSC 41 at paras 21-25 – provided in the Judicial Statement

**2.46** According to HMRC, what the parties call their relationship, or what they consider it to be, is not conclusive. It is the reality of the relationship that matters. Nevertheless, the intention of the parties has to be taken into account. The intention can be decisive where the relationship is ambiguous and where the other factors are neutral.<sup>60</sup>

## Equipment

**2.47** The equipment test is another indecisive factor. In days gone by, owning your own equipment may have been an important factor in proving your employment status. These days where all you need is a computer, it may seem simple, but then you have to factor in the security measures that businesses have to put in place. One participant pointed out that it would not be feasible to allow a contractor to bring their own equipment because it could not be connected to the corporate network due to security measures.

**2.48** In the Employment Status Manual<sup>61</sup>, HMRC point out that the equipment should be 'necessary' or 'essential' but *Lorimer* disputes that. The vision mixer in *Lorimer* was found to be self-employed for tax purposes despite the fact that the substantial and expensive equipment needed was provided by the engager. In some countries<sup>62</sup>, the equipment test is split into different types of equipment e.g. essential tools of the trade, motor vehicles and heavy plant or equipment, which can provide more relevance.

## The whole picture

**2.49** In 1994, in *Lorimer* we were told that: *"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. 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. The process involves painting a picture in each individual case."*

**2.50** The last sentence sums up the feeling of several legal commentators who were interviewed by the OTS. They felt that as soon as one case establishes a legal point, it will be distinguished by the next tribunal on its facts, thereby providing no consistency or certainty other than on those individual facts.

## Conclusion

**2.51** As the recent case of *Stack* has shown, interpreting the law in employment status is not easy. What is clear is that, taken as a whole, the body of case law in employment status looks like an unwieldy mess, but taken apart it does make some sense<sup>63</sup>.

**2.52** There are common threads that run through the developing case law, for example those based on tax rather than employment rights, or those based on a written contract, rather than an oral agreement.

**2.53** In using case law to advance the position either in terms of a statutory test or other measures that are recommended as part of this report, certain case law has stood the test of time. One such test that has been referred to time and time again is the MacKenna test in *Ready Mixed Concrete*.

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<sup>60</sup> ESM 0554 - Guide to determining status: intention of parties

<sup>61</sup> ESM 0540 - provision of equipment

<sup>62</sup> In the Australian employment status decision tool - see Chapter 5

<sup>63</sup> Various lawyers who were interviewed by the OTS didn't think there was a problem with interpreting employment status.

## Quasi-statutory tests and rules

**2.54** As previously mentioned, in the UK and, it seems, the rest of the world bar a few exceptions,<sup>64</sup> employment status is decided by case law on the basis of the various tests and factors derived from those cases. As will be explored later, the OTS are considering the use of a statutory employment test.<sup>65</sup> As the result of an overwhelming desire for certainty, most people we spoke to were in favour of a statutory employment test in principle, although the form of such a test was not clear and there was great concern about how practical it would be.

**2.55** The statutory employment test could be either qualitative or quantitative. If it was qualitative, the test could be based on a reflection of the case law. The worry here, from commentators, was that it would be nearly impossible to create a test based on case law because there are too many variables.

**2.56** Drawing from international experience in the USA, for example, there are different tests under different statutes. This created a conflict which the Supreme Court of New Jersey recently had to consider. The Fair Labour Standards Act uses the test of economic reality, whereas under the New Jersey Unemployment Compensation Act<sup>66</sup>, the 'ABC' test is used<sup>67</sup>. So the court had to decide which test was appropriate for the purposes of resolving a wage-payment or wage-and-hour claim<sup>68</sup>.

**2.57** In introducing a statutory employment test, the OTS would have to consider whether it would be solely for the purposes of determining tax status or as a dual test to also determine employment status. The American example above may be good evidence not to have more than one test, although one leading legal academic suggests otherwise, saying that there should be only one test for tax purposes. It may be helpful, therefore, to assess what rules are already in place that dictate, in part, the employment status of certain individuals.

**2.58** The majority of these statutory measures involve the trinity of supervision, direction and control. One of those we interviewed commented that the key test for employment status is the degree of direction, supervision and control, and any worker engagement has an element of all three. The following are the main examples of these measures in the UK legislative code.

## Onshore intermediaries: false self-employment

**2.59** The newest example is as a result of the onshore intermediaries legislation which has rewritten the agency tax legislation<sup>69</sup>. This legislation was strengthened to tackle the use of employment intermediaries facilitating false self-employment to avoid employment taxes:

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<sup>64</sup> Chapter 5 - International comparisons

<sup>65</sup> Chapter 9 - Statutory employment test

<sup>66</sup> Annex I International case studies (N.J.S.A.43:21-19(i)(6))

<sup>67</sup> The ABC tests is detailed in Chapter 5. In outline, an individual will be treated as an employee unless they meet all three tests set out in the statute – the A/B/C subsections each having a separate test.

<sup>68</sup> Similar to the UK National Minimum Wage legislation.

<sup>69</sup> Sections 44-47 ITEPA 2003

#### Box 2.F: Section 44(2) ITEPA 2003: Treatment of workers supplied by agencies

2. ... this section does not apply if -
  - (a) it is shown that the manner in which the worker provides the services is not subject to (or to the right of) **supervision, direction or control** by any person

**2.60** To accompany the change in legislation, HMRC produced a guidance document on supervision, direction and control. This supplements the information already provided in the Employment Status Manual<sup>70</sup>. First, it is noted that this is a 'qualifying condition' which must be satisfied before the provisions of the agency legislation can apply. Secondly, the manner in which the person provides the services must be subject to supervision, direction or control or "...the right of..."<sup>71</sup>, the latter referring to a contractual right whether the right is exercised in practice or not. Thirdly, supervision, direction or control can be exerted by "...any person...", not just the person the worker has been supplied to work for.

**2.61** HMRC have accepted the courts' interpretation of what constitutes 'control' for the purposes of employment status. Accordingly, HMRC rely on the leading authority on employment status of the *MacKenna Test*, which is stated as the first case to place the importance of control when determining employment status. HMRC also rely on *Autoclenz*, *Talentcore Ltd*<sup>72</sup> and *Serpol* and the issue of 'right' of control is clearly emphasised.

**2.62** In all of the examples given in the guidance document, the individual only has a contract with an employment business and themselves, under which they provide their services to end clients. They do not enter into a contract with any of the end clients and they are not providing their services through a personal service company, a managed service company or an umbrella company.

### Agency workers regulations 2010

**2.63** Whether the agency workers regulations apply or not is determined by the definition of what an agency worker is or is not. Although this is for employment rights purposes, it is another example, although only supervision and direction are used in this measure and only by the hirer in practice – see Box 2.G.

<sup>70</sup> *ESM 2005* - Agency and temporary workers: right of supervision, direction or control; *ESM 0526* - Guide to determining status: control over how the work is done; *ESM 0528* - Guide to determining status: control over experts

<sup>71</sup> *Serpol Ltd v Revenue & Customs* [2011] UKFTT 174 TC

<sup>72</sup> *Talentcore Ltd (t/a Team Spirits) v HMRC* [2011] UKUT 423 (TCC) – ESM7315

### Box 2.G: Agency workers regulations 2010 – meaning of agency worker

3.
  - (1) In these Regulations “agency worker” means an individual who
    - (a) is supplied by a temporary work agency to work temporarily for and under the supervision and direction of a hirer; and...
  - (2) But an individual is not an agency worker if
    - (a) the contract the individual has with the temporary work agency has the effect that the status of the agency is that of a client or customer of a profession or business undertaking carried on by the individual; or
    - (b) there is a contract, by virtue of which the individual is available to work for the hirer, having the effect that the status of the hirer is that of a client or customer of a profession or business undertaking carried on by the individual.

**2.64** The latter part of the definition concentrates on the type of contract the worker works under, this is so those who are genuinely self-employed or personal service companies are not governed by the regulations. There was no opt-out provided because of the risk of abuse, that unscrupulous agencies may have just forced workers to operate under a personal service company.

### Limited liability partnerships (LLPs)

**2.65** The law<sup>73</sup> for LLPs provided that any individual LLP member was treated as self-employed for tax purposes, subject to income tax and Class 4 NICs on the partnership profit share. The rule was intended to treat LLP members in the same way as partners in traditional partnerships.

**2.66** In deeming all individual LLP members to be self-employed, the existing tax rules go further than simply aligning their status with that of individuals in a traditional partnership. An individual has to have the characteristics of a partner to be determined as such in a traditional partnership. However, in an LLP, an individual needs only be registered as a member. Over the years, it has become evident that many LLPs have members who are engaged on terms similar to those of employees rather than traditional partners.

**2.67** The new ‘salaried members’ rules were introduced in 2014<sup>74</sup> to address this inconsistency, with the aim of making the rules fairer across partnership types. LLP members who are, in effect, providing services on terms similar to employment, are treated as ‘employees’ for tax purposes. Associated changes to the NICs legislation have been made by the National Insurance Contributions Act 2014. The rules are for tax purposes, so they are independent of employment law and vice versa.

**2.68** The legislation also contains anti-avoidance provisions meaning any arrangements with a main purpose of circumventing these salaried member rules will be disregarded when applying the rules.

<sup>73</sup> Section 863 of Income Tax (Trading and Other Income) Act 2005 (ITTOIA) – see new rules in Annex D

<sup>74</sup> See section 74 and schedule 17 FA 2014



## HMRC Rules

**2.69** HMRC have agreed a number of easements and concessions in particular occupations that vary the general rules on employment status. These are as a result of an agreement between HMRC and a representative body or NICs Categorisation regulations.<sup>75</sup>

**2.70** There are, for example, two special rules in the Film and TV Production industry, the 'Seven Day' rule and the 'Nine Month' rule<sup>76</sup>. Neither rule appears to have any basis in statute or case law, but they are guidance from HMRC which have been adopted by and complied with in the industry.

## Categories of workers

**2.71** Various categories of workers have been identified as affected by employment status and although legally there is no definition, they can loosely be grouped into categories as shown in Annex E.

## Personal service companies and professional contractors

**2.72** On the one end of the scale there are those that are paid well and provide their services through an intermediary such as a limited company or LLP<sup>77</sup>. They determine their own status by incorporation and are aware of employment status implications, but are then at the behest of IR35 and other legislation. Their tax status is determined by the employment status case law, despite the protection of the limited company structure, as a result of IR35.

**2.73** They are aware that they do not have any employment rights, nor do they expect entitlement to sick pay, holiday pay, etc., from the engager. It is often debated whether a director of a personal service company is also an employee of their own limited company. If they were then, as an employee, they would be entitled to employment rights. Although, realistically if there is no genuine contract of employment and the individual can prevent their own dismissal, it is unlikely that they would be found to be an employee of their own limited company.

**2.74** At the other end of the scale, there are the workers who are forced to provide their services as self-employed, sometimes using an intermediary such as a partnership<sup>78</sup>. Few are even aware that they are self-employed and often don't understand the implications. They are given a contract and have to sign it or they can't work. The engager pays them gross and there are few or no employment rights. Some are paid below National Minimum Wage, because it doesn't apply unless the individual is a limb b worker or employee.

## Agency workers

**2.75** Many individuals who would otherwise be self-employed provide their services through a personal service company, when working through an agency. This can either be because it is tax efficient for the individual, or because the agency would otherwise be exposed to a tax liability. The tax liability derives from the agency tax legislation<sup>79</sup> which puts the burden of tax on the employing company if it is found that the individual has been misclassified. These same

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<sup>75</sup> Discussed in more depth in Chapter 3 - Particular occupations

<sup>76</sup> See para. 3.22 – 3.26 in Chapter 3 – Particular occupations.

<sup>77</sup> Section 863 of Income Tax (Trading and Other Income) Act 2005

<sup>78</sup> *Protectacoat Firthglow Ltd v Szilagyi* [2009] EWCA Civ 98 CA

<sup>79</sup> Section 44 ITEPA 2003 – application of provisions to agency workers



individuals may not, however, be an “agency worker” for the purposes of employment rights legislation under the Agency Workers Regulations 2010.

**2.76** The practice of supplying individuals through intermediaries such as personal service companies, is quite sector specific, it being more prevalent in the IT, engineering and planning sectors, for example. Other agency workers may be treated as employees for tax purposes where they do not fall into the exclusions of the agency tax legislation or may be supplied through an umbrella company<sup>80</sup>.

## Office holders

**2.77** Office holders<sup>81</sup> are neither employees nor workers, but they may have to pay PAYE and NICs as an employed earner on any payments or honoraria if the legislation applies.<sup>82</sup> Recent changes to the IR35 legislation have added ‘office holders’: this is in order to curtail the practice of supplying the services of an ‘office holder’ to a client under a contract directly between the individual and the client.

## Interns

**2.78** There is no legal definition of ‘intern’ and no specific legislation covering the status for employment or tax purposes. The status of an intern is, therefore, defined by there being a reclassification of their status to either limb b worker or employee for employment rights purposes. It is thought that many interns should receive the national minimum wage if they are required to work. Interns may receive expenses but a payment of estimated unreceipted expenses, even if the amount is less than that expended, may trigger a status dispute for tax.

## Volunteers

**2.79** Volunteers are defined “...as a person engaged in an activity which involves spending time, unpaid (except for travel and other approved out-of-pocket expenses), doing something which aims to benefit some third party other than or in addition to a close relative.”<sup>83</sup> A volunteer is not entitled to the national minimum wage if the specific legislation applies.<sup>84</sup> There may, however, be a status dispute concerning a reclassification for tax purposes as an ‘office-holder’. Also where the volunteer has received expenses, especially estimated unreceipted expenses even if the amount is less than that expended, this may trigger a status dispute for tax.

## Legislative drivers

**2.80** There is, however, a current and worrying trend that inappropriate vehicles are being used to provide the services of semi-skilled or unskilled workers in order to bypass legislation, avoid the National Minimum Wage and tax and, more specifically, employers’ NICs. This is not a new phenomenon as was seen in the mid-70s when the amendments to legislation in the construction industry resulted in wide use of the personal service company.

**2.81** The use of personal service companies grew in the late 1980s when the amendments to what was section 134 Income and Corporation Taxes Act 1988<sup>85</sup> were made. After the ‘agency tax’ legislation was enacted in 1988, it became established practice to provide the services of an

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<sup>80</sup> Employment Intermediaries: Temporary workers – relief for travel and subsistence expenses

<https://www.gov.uk/government/consultations/employment-intermediaries-temporary-workers-relief-for-travel-and-subsistence-expenses>

<sup>81</sup> See Chapter 4 - Office holders

<sup>82</sup> Section 5 ITEPA 2003 – application to offices and office holders

<sup>83</sup> Police Act 1997 (Criminal Records) Regulations 2002 and also in the Compact Code of Good Practice on Volunteering.

<sup>84</sup> Section 44 National Minimum Wage Act 1998 – voluntary workers.

<sup>85</sup> Now section 44 ITEPA (consolidating legislation from 1975 in section 38 Finance (No.2) Act and then in 1978 in the Social Security (Categorisation of Earners) Regulations for National Insurance.)

individual through a limited company, either to protect the agency from a tax liability or as a more tax efficient vehicle for the individual. As a result of the growth of personal service companies in 1999, IR35 was introduced<sup>86</sup>. In order to bypass the IR35 legislation, managed service companies became popular, but this deprived the Exchequer of tax and as a result, in 2003 the managed service company legislation<sup>87</sup> was enacted. This legislation has all but closed down the use of managed service companies to avoid tax.

**2.82** In the last couple of years the onshore and offshore intermediaries legislation has been brought in to prevent what is seen by the government as ‘false self-employment’. As an indirect result of the legislative changes, the ‘umbrella’ company has become an established way of payrolling the services of individuals, but technically, these individuals are either limb b workers or employees.

## Avoidance of obligations

**2.83** It appears that some employers are using ever more creative methods to avoid their obligations in tax and employment rights. Some employers are forcing individuals to contract through a limited company even though the pay is low, this is in part to avoid the National Minimum Wage legislation. There is also evidence<sup>88</sup> that employers are contracting workers on zero hours contracts and giving them few enough hours not to trigger the lower threshold for Class 1 employers’ secondary NICs. Employers are also contracting individuals on apprentice schemes, sometimes without the individual’s knowledge, because a lower rate of National Minimum Wage applies.

## Conclusion

**2.84** Ideally there would be an agreed, coherent set of principles developed from case law to guide and govern decisions on employment status. In an ideal world that set of principles would apply to all relevant areas: tax, National Minimum Wage, benefits and employment law. However desirable, that goal seems unlikely to be achieved, not least because of constantly changing circumstances and the tendency of cases to be taken that seek to distinguish previous decisions. It would, though, be the basis of a statutory test if it is decided to introduce one<sup>89</sup>.

**2.85** One advantage of an agreed set of principles would be that where decisions are taken to introduce statutory rules, there would be clear bases for the changes. Whether or not the set of principles can be developed, any statutory changes that are made need to assess the impact on the general principles that do exist as part of the process of consultation.

**2.86** Assuming that a set of agreed principles cannot be developed, for general agreement, it is surely desirable that for tax purposes some clearer guidance is developed, including principles for tax purposes. We wonder if that could be developed by a suitable working party with input from the sort of wide stakeholder group that the OTS has consulted. At present, businesses and especially individuals find it difficult, if not impossible, to be certain of an individual’s employment status. This should naturally feed into work on enhancing the employment status indicator tool.<sup>90</sup>

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<sup>86</sup> The IR35 legislation is more formally Section 60 and schedule 12 FA2000, now sections 48-61 ITEPA 2003

<sup>87</sup> Chapter 9, Part 2 and Section 688A, Part 11 Income Tax (Earnings and Pensions) Act 2003

<sup>88</sup> Dispatches – *Low Pay Britain* Channel 4 – first aired Monday, 19 January 2015 - <http://www.channel4.com/info/press/news/low-pay-britain-channel-4-dispatches>

<sup>89</sup> See Chapter 9 - Statutory Employment Test

<sup>90</sup> See Chapter 8 - Employment status indicator tool

**Box 2.H: Recommendation**

It is recommended that there is a joint review between the HMRC, HMT, DWP and BIS which looks at the possibility of developing an agreed code of principles on employment status.

In any event, there should be work carried out, preferably by a joint group, to develop better guidance for the average individual and small business of the rules on employment status.

## 3 Particular occupations

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**3.1** This chapter considers two broad routes by which the general rules on employment status are varied:

- Occupations that have sets of guidelines for the tax and/or NICs treatments, often resulting from HMRC coming to an agreement with a representative body
- Occupations that are the subject of the NICs Categorisation regulations, often resulting in the income being treated differently for NICs purposes than for income tax

**3.2** Our reason for looking at these issues is to assess their success (or shortcomings). Are they routes that should be emulated? Or eliminated?

### Introduction

**3.3** A chapter of HMRC's employment status manual (ESM) is devoted to 'particular occupations'<sup>91</sup>, and there are 65 pages covering these cases. The full list of these cases is set out in Annex F. These notes are clearly helpful to the occupations concerned, and professional advisers have told us they would like to see further guidance, to cover common groups where employment status is an issue. However, we have also heard that there is scope for unfairness, particularly if a special practice is not suitably publicised.

**3.4** Whilst current guidance frequently states that determination of status is reliant on applying the normal tests to the facts of the case, there are a number of examples where the likely status is given by HMRC guidance, or a special practice applies, and these are set out in the following paragraphs. However, in many of these cases, such treatment is only applicable for income tax purposes, with an inconsistent result applying for NICs purposes.

### Cases set out in HMRC's employment status manual where a special practice applies

**3.5** Those cases where a special treatment is provided are set out below:

#### Careworkers

**3.6** Careworkers<sup>92</sup>, providing care in the careworker's home, are usually treated as self-employed for tax purposes, and liable to class 2 and 4 NICs. These are general guidelines, except where HMRC have entered into an agreement with the relevant national association or representative body.

#### Dentists and doctors

**3.7** Dentists<sup>93</sup> and doctors<sup>94</sup> with full- or part-time appointments with the National Health Service, are generally in an office or employment. However, earnings from a part-time office or employment may in practice be treated as professional receipts under trading income rules,

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<sup>91</sup> ESM 4000 onwards

<sup>92</sup> ESM 4015

<sup>93</sup> ESM 4030

<sup>94</sup> ESM 4060-4062

where the dentist or doctor so wishes and the earnings are small in comparison to the professional receipts assessable as trading income<sup>95</sup>.

**3.8** These rules apply to all forms of professional income under the administrative practice EIM 03002 where practical difficulties would apply if the fees were treated in their strict form as employment income and the duties of the office or employment are small in relation to the practice work and are in a field related to the profession and practice concerned. In the case of a partnership, there is an agreement that the fees can be pooled for division amongst the partners under the agreement.

**3.9** However, this treatment only applies for income tax purposes, so class 1 NICs remain payable in the normal way.

**3.10** We heard from professional advisers to general practitioners (GPs), who consider that given the wide variations in the way in which a GP can provide his or her services, and the varying nature of the work undertaken outside of normal surgery appointments, there was surprisingly little HMRC guidance.

**3.11** There was concern that the easement described above was likely to be withdrawn as part of the programme to reduce the number of concessions, following the House of Lords decision in the Wilkinson<sup>96</sup> case.

**3.12** HMRC issued a review document proposing withdrawal of EIM 03002 subject to a consultation period from 6 October 2014 to 8 January 2015<sup>97</sup>.

**3.13** We heard that GP practices relied increasingly on this easement, and are concerned that the review document mentions the Department for Environment, Food and Rural Affairs (DEFRA) as the main users, with a special concession being organised, but is silent on GP and other professional practices.

**3.14** From a simplification point of view, EIM 03002 has much to recommend it. The OTS accepts that it varies the strict rules of taxation but the results achieved are simpler and in many ways better reflect how the taxpayers see their activities. We appreciate the reasons for reviewing its operation of ESCs and concessions but do have concerns that the document proposing withdrawal did not have regard to the GPs' situation. We trust that such considerations are being taken into account in considering the way forward.

## Company directors

**3.15** A company director<sup>98</sup> holds an office, and any emoluments are therefore chargeable as employment income, and subject to class 1 NICs. For tax purposes, there are two exceptions to this, which are covered under Extra Statutory Concession A37<sup>99</sup>, namely:

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<sup>95</sup> Administrative practice at ESM 03000 onwards

<sup>96</sup> *R v Commissioners of Inland Revenue, ex parte Wilkinson* [2005] UKHL 30

<sup>97</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/362505/141002\\_withdrawing\\_ESCs\\_con\\_doc\\_v4.0.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/362505/141002_withdrawing_ESCs_con_doc_v4.0.pdf) HMRC told the OTS: "The administrative practice EIM 03002 was announced in October 14 for withdrawal in April 2016. A consultation completed in January 2015 and the results will be reported later this year. The concession allows certain professionals to treat their employment income as trading income subject to strict conditions. There is also a separate administrative practice at EIM61030 which applies only to doctors who sit on Local Medical Committees. This has not been announced for withdrawal yet but we are meeting with an association of accountants representing the sector to explore whether there are any mitigating circumstances to consider. This will help in deciding whether to withdraw the concession or legislate."

<sup>98</sup> ESM 4040/4240

<sup>99</sup> ESC A37 mirrors the NICs rules contained in Regulation 27 of the Social Security (Contributions) Regulations 2001

**3.16** Where a director of Company A is appointed to the Board of Company B as a nominee of Company A, and hands over the fees from Company B to Company A, those fees may be assessed on Company A rather than the director.

**3.17** Where a director is a member of a professional partnership, and the directorship is a normal incident of the profession and of the particular practice concerned, the fees are only a small part of the profits, and under the partnership agreement the fees are pooled for division among the partners, then the fees may be assessed as trading income as part of the partnership receipts<sup>100</sup>.

**3.18** We were told that in practice ESC A37 and Regulation 27 are valuable administrative easements in that they help align the tax treatment of the fees with the commercial reality of the situation. There seems to be quite wide usage, including by law and accountancy firms and by private equity funds where individuals are appointed onto portfolio company boards. Concern was expressed that this concession may disappear as part of the general review of concessions. **It seems to us that there is a strong case for its being put into legislation to give greater certainty.**

## Voluntary workers

**3.19** Voluntary workers<sup>101</sup> for voluntary organisations are not normally engaged under a contract of employment, and will not normally be the holder of an office. The reimbursement of any expenses incurred in carrying out the work, or expenses of travel from home to the place of work will therefore not give rise to a liability to tax. However, where expenses are paid which do more than reimburse the costs incurred, the HMRC position is that the voluntary worker may be receiving remuneration for their services. A charge to income tax would then arise under employment income if it can be shown an office or employment exists, or otherwise under section 687 ITTOIA 2005.

**3.20** Voluntary workers are also referred to within Chapter 2: Legal background.

## Divers and diving supervisors

**3.21** A diver, or a diving supervisor,<sup>102</sup> conducting diving operations in the UK or a designated area<sup>103</sup> concerned with the exploration or exploitation of the seabed, subsoil and their natural resources, is treated as the carrying on of a trade in the UK.<sup>104</sup> However, for NICs purposes, the status is determined by the usual tests, but subject to a specific exemption from class 4<sup>105</sup> NICs.

## Behind camera workers

**3.22** Behind camera workers<sup>106</sup> in film, video, TV and radio, in certain 'grades' in the industry, are automatically accepted by HMRC as assessable to tax on trade profits, and liable to class 2 and 4 NICs, provided they fulfil specific requirements set out in the 'grading list'<sup>107</sup>. This follows a review of the work undertaken by these grades within the industry. The requirements are that they be engaged on a temporary, casual, or freelance basis:

- for a one-off production such as a feature film or single drama or documentary, or

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<sup>100</sup> See Employment Income Manual (EIM) 02500

<sup>101</sup> ESM 4530/EIM 71100

<sup>102</sup> ESM 4050

<sup>103</sup> Section 1 (7) Continental Shelf Act 1964

<sup>104</sup> Section 15 Income Tax (Trading and Other Income) Act 2005

<sup>105</sup> Regulation 92 SS (Contributions) Regs 2001

<sup>106</sup> ESM 4103/4112

<sup>107</sup> Film, TV and production industry guidance notes – August 2012 (archived – but still used in practice)

<http://webarchive.nationalarchives.gov.uk/20140109143644/http://www.hmrc.gov.uk/specialist/fi-notes-2012.pdf>

- for less than 9 months on a series or a specific strand of a programme.

**3.23** In exceptional circumstances the period of 9 months may be extended if specific authority is sought from the HMRC film industry unit.

**3.24** We heard from a worker within the industry who found the operation of the specific requirements to be complicated, in particular the nine month maximum duration of engagement on a series. The query was raised as to why it was necessary to take a three month natural break, when the work previously undertaken only amounted to ten weeks, i.e. considerably less than the nine month maximum period?

**3.25** An HR professional for a major film company told us:

**Box 3.A: Quote from HR professional in the film industry**

*"We struggle with the Appendix 1 guidelines for the film, TV and broadcast industry, such as equipment provision, job titles and contract lengths and the nuances between in front of and behind camera. An up-to-date version is required."*

**3.26** The normal operation of PAYE is impractical and would in many cases result in excessive deductions of tax for many employed workers in the film, production & TV broadcasting industry, since they have short engagements with a succession of different employers. A seven day rule is applied to alleviate the hardship which might arise from such excessive deductions. There is no need to apply PAYE to payments made to workers engaged for less than one week, i.e. for six consecutive days or less.

**3.27** This rule applies only to income tax, but does not apply to NICs, which must be accounted for in the normal way. Operation of the seven day rule does not change the nature of the contract and the worker remains an employee.

**3.28** The OTS notes that the grading list and requirements no longer appear to be available on the HMRC website (apart from the archived copy from 2012), and understand from HMRC that the guidance is currently under review. **We call for up to date guidance, with clear signposting from gov.uk, to be fully available once again.**

**3.29** Theatrical performers and artists<sup>108</sup> who had received a number of Schedule D (trading income) assessments prior to April 1990 were granted reserved trading income status under Extra Statutory Concession A75. The decision in the McCowen and West Special Commissioners case changed the view of HMRC on many standard industry contracts, and it is now accepted that performers/artists are generally assessable to tax as trade profits, with liability under class 4 NICs, as a matter of law rather than by concession. This will include stage management roles with a standard Equity contract.

## Designers, directors and choreographers

**3.30** Designers, directors and choreographers<sup>109</sup> in the entertainment industry may be engaged under a contract for services or a contract of employment. However, self-employment status is accepted by HMRC where engaged for a specific production, for a limited period ending soon after the production opening, and where payment consists of both a fee and a royalty.

<sup>108</sup> ESM 4121

<sup>109</sup> ESM 4126



## Sub-postmasters

**3.31** The remuneration of a sub-postmaster or sub-postmistress<sup>110</sup> is strictly chargeable as employment income. However where a retail trade or business is carried on from the same premises, in practice the remuneration may be included with trade receipts and taxed accordingly. But this practice does not extend to NICs, meaning that the Post Office is liable to pay secondary class 1 NICs, and the sub-postmaster/mistress liable to primary class 1 NICs. This amount will, however, be exempt from class 4 NICs.<sup>111</sup>

## Local Veterinary Inspectors

**3.32** Local Veterinary Inspectors<sup>112</sup> are office holders, appointed by the Department for Environment, Food and Rural Affairs (DEFRA). Under the payment system, fees for the work are paid to the veterinary practice, a partner or a salaried employee. To ease administration, HMRC have advised DEFRA to pay all such fees gross, with the fees to be declared by the veterinary practice in their trading accounts. However, the fees remain earnings for class 1 NICs purposes.

**3.33** The OTS understand the reasons for the practices set out above. Inevitably, however, this creates borders and inconsistent results. We heard from a self-employed special effects film technician, who told us:

### Box 3.B: Quote from a film industry special effects technician

*"I am self-employed. Every time I secure work on a big show, a structure of rules are enforced and suddenly people start saying "you have to go on PAYE unless you are a senior tech. This means that I am placed on PAYE and taxed at the emergency coding rate, with class 1 national insurance contributions for the whole 3 weeks I am on the show. This is wrong! My rating as a 'senior' tech as opposed to a tech is entirely a matter for my union and its rules have no basis in law, it is merely a club that I can join."*

**3.34** The easements and concessions discussed above generally make the tax system simpler for those involved. In principle, the OTS has to support them. However, they do raise issues of fairness (should they be available more widely? Are they fair to the general body of taxpayers?). Assuming HMRC are satisfied they are a fair use of their administrative powers, the OTS considers that if the easements and concessions set out in the above paragraphs are to be continued with, they should be formalised in Statements of Practice and given proper publicity. Particular grading lists and the basis of the agreements should be set out in HMRC guidance.

**3.35** These arrangements should be consistent for both tax and national insurance purposes. The point on consistent treatment for income tax and NICs is taken up further in the paragraphs below regarding the categorisation regulations.

## Social security categorisation of earners regulations

**3.36** The categorisation regulations<sup>113</sup> were introduced in 1978, primarily for the purpose of protecting contributory benefits for the individuals concerned. They categorise certain types of

<sup>110</sup> ESM 4400

<sup>111</sup> Regulation 94A of the Social Security (Contributions) Regulations 2001.

<sup>112</sup> ESM 4200

<sup>113</sup> Statutory Instrument 1978/1689 (Northern Ireland SR 1978/401)



workers as ‘employed earners’ for NICs purposes, even though they are not normally considered to be employees for the purposes of income tax or employment law.

**3.37** See Box 3.C. for a list of employed earners for NICs purposes.

**3.38** The objective of repealing the lecturers/teachers/instructors category 4 in the list below was primarily one of simplification. HMRC’s interpretation of the regulations as a result of the *St John’s College School* case<sup>114</sup> was that they applied in certain circumstances to some vocational and recreational tuition. HMRC admitted that subsequent guidance in this area had caused uncertainty over the extent of the category’s application, and following a period of research and consultation, the regulation was revoked.

**3.39** A similar consultation was launched by HMRC in May 2013<sup>115</sup> in respect of the categorisation regulations applying to entertainers. Practical difficulties in the operation of class 1 NICs were being experienced, creating uncertainties for both entertainers and their engagers. Two examples cited in the consultation document were ‘additional use payments’ possibly arising months or years after the engagement had ended, and for musicians (who may undertake many engagements in one day). The musicians were previously thought to be engaged on contractual terms outside the regulations, but in light of the decision in the *ITV* case<sup>116</sup> were then considered to be engaged under terms that were so caught. Again, for purposes of simplification, the decision was taken to repeal the regulation for this category.

**3.40** The OTS has noted that a new paragraph in HMRC’s employment status manual, ESM 4148 has been introduced to reflect the repeal, and we understand HMRC are currently reviewing other references within this section of the ESM yet to be updated.

**3.41** Conversely, Part II of the categorisation regulations<sup>117</sup>, provides that examiners, moderators, invigilators etc. or question setters for examinations leading to any certificate, diploma, degree or professional qualification, are treated for NICs purposes only as self-employed if the whole of the work is performed under a contract of less than 12 months. This will give rise to liability to pay class 2 NICs and where profits exceed the lower limits, class 4 NICs.

**3.42** Under Part III, fees received by election returning officers and their staff for duties performed at parliamentary and local elections (which are chargeable to income tax as employment income) are specifically disregarded for NICs purposes<sup>118</sup>.

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<sup>114</sup> *St John’s College School, Cambridge v Secretary of State for Social Security* (Unreported) [CO/3246/99]

<sup>115</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/198510/HMRC\\_Consultation\\_NICs\\_and\\_SEEnts\\_-\\_MAY\\_2013\\_final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/198510/HMRC_Consultation_NICs_and_SEEnts_-_MAY_2013_final.pdf)

<sup>116</sup> *ITV Services Ltd v Revenue And Customs* [2013] EWCA Civ 867

<sup>117</sup> Paragraph 6 Part II of Schedule 1SI 1978 No. 1689

<sup>118</sup> Paragraph 10 Part III of Schedule 1 SI 1978 No. 1689

### Box 3.C: Social security categorisation regulations for NICs: employed earners

1

- (i) An office cleaner other than in premises used as a private dwelling house, and
- (ii) A cleaner of telephone apparatus and associated fixtures, other than in premises used as a private dwelling house

2

Employment where-

- (i) a person (worker) personally provides services to an end client
- (ii) there is a contract between the end client (or someone connected to them) and an agency, under the consequences of which
  - (i) the services are provided, or
  - (ii) the client pays, or otherwise provides consideration for the services,
  - (iii) the worker receives remuneration as a consequence of providing the services
  - (iv) someone has a right of supervision, direction or control over the manner in which the worker provides the services
  - (v) the worker is not providing exempt services (as prescribed)

3 Employment of a person by his or her spouse/civil partner for the purpose of their employment

4 Lecturer, teacher, instructor or in any similar capacity, excepting where instruction no more than three days in three consecutive months or as public lectures – repealed from April 2012

5 Ministers of religion, excepting where remuneration (disregarding payments in kind) does not consist wholly or mainly of stipend or salary

6 Entertainers in receipt of salary for services rendered, under a contract for services, payable for a specific period or interval, and computed by reference to the amount of time for which work has been performed – repealed from April 2014

**3.43** Many of the responses reported in the response document<sup>119</sup> to the above consultation on entertainers cited the inconsistency of treatment between income tax and NICs as a reason for change. This echoes feedback the OTS received across many of our earlier reviews<sup>120</sup>.

**3.44** Our Small Business Review found differences between tax and NICs to be the second highest source of complexity for small businesses. The particular anomalies, and the steps that would be necessary in integrating the two systems into a single tax are set out in Chapter 10 of this report. One step would be to align the underlying bases of income for tax and NICs

<sup>119</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/251925/National\\_insurance\\_and\\_self-employed\\_entertainers\\_-\\_response\\_document.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/251925/National_insurance_and_self-employed_entertainers_-_response_document.pdf)

<sup>120</sup> Small Business Review, Employee Expenses and Benefits Review, and Review of UK Competitiveness

purposes, and the different treatment set out in the special cases and the categorisation regulations above run contrary to this objective.

**3.45** We understand that HMRC do not hold statistics on the number of individuals remaining within the categorisation regulations, but numbers affected are clearly reduced following the repeals for lecturers and for entertainers. We have heard anecdotally that the category for cleaners of telephone apparatus relates to telephone kiosks, now rarely seen away from tourist areas, further diminishing the number of individuals working in this category.

**3.46** We were also told that ministers of religion were unlikely to fall within these rules, since they would normally be classed as an office holder or an employee.

**3.47** With the exception of Category 2 above (a parallel regulation for NICs to section 44 ITEPA 2003 for income tax, the treatment of workers supplied by agencies), the question arises whether the reason for the introduction of these regulations, i.e. protection of contributory benefits, remains relevant today.

**3.48** A possible reason protection was considered to be necessary lies in the different classes of contribution, and the benefit entitlements that result. The National Insurance Act 1946 introduced three classes of contribution: class 1, 2 and 3, with class 1 payable by employees and employers (primary and secondary contributions respectively), class 2 by the self-employed and class 3 as voluntary contributions. Because the class 2 contribution levels were falling short of class 1 contributions, an additional class 4 contribution was introduced on the self-employed in 1975, but with no benefit entitlements.

**3.49** A table listing benefits available per NICs classes is set out in Table 3 in Annex H. The reduction in numbers of benefits relying on the contributory principle leave only four that remain available to employees which are not available to the self-employed:

- contributory based job seekers allowance
- statutory maternity/paternity/adoption pay
- statutory sick pay
- state second pension, state graduated pension, state earnings related pension (SERPS)

**3.50** Of these, the state pension is of course by far the largest in terms of cost. However, the proposal for a flat rate state pension payable from April 2016 further reduces the link to paying NICs.

**3.51** The OTS have held a number of meetings with representative bodies and advisers, and could find no support for continuing the categorisation regulations.

**3.52** The OTS recommend a review be launched into these regulations, with a view to their abolition. The aim would be to have a single set of rules, rather than a range of rules that override the main rules in some circumstances and which can result in differing treatments of the same income for income tax and NICs purposes.

## 4 Office holders

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**4.1** The inclusion of income from an ‘office’ in the ambit of income tax dates from the earliest days of income tax. Without the extension of the employment income rules to cover offices and offices holders, fees received from an office would escape any charge to income tax. This is because they derive from neither a contract of employment, nor a trade, profession or vocation which is subject to a separate set of tax rules as self-employment.

**4.2** It is questionable how much this distinction is recognised outside the tax profession. It would no doubt strike most ordinary individuals as very odd if the income from such activities were not included in the income tax net.

**4.3** Before 2003, income from an employment or office were taxed under Schedule E of the old schedular system for charging income to tax. The Schedule E charge was replaced with a charge to tax on employment income in the 2003 Income Tax (Earnings and Pensions) Act and the terms ‘employment’ and ‘employee’ were defined to include ‘offices’ and ‘office holders’.<sup>121</sup>

**4.4** For the purposes of the 2003 Act, the term ‘office’ includes in particular any position which has an existence independent of the person who holds it and may be filled by successive holders. The most common form of office holder is a company director. Others include non-executive directors, charity trustees and some clergymen.

### The NICs position

**4.5** Turning to NICs, there have at times been differing results for office holders. Section 15 of the National Insurance Contributions Act 2014 corrected an error in ITEPA 2003 when the new term ‘general earnings’ for tax led to consequential changes to NICs legislation. The section ensures that all office holders are included in the definition of employed earners for NICs purposes, provided that they receive earnings as defined by either the Social Security Contributions and Benefits Act 1992 or the Social Security Contributions and Benefits (Northern Ireland) Act 1992.

### Should ‘office holder’ continue?

**4.6** Although the office holder term is rather archaic, it seems to be necessary to retain it in legislation and it appears to be well-understood. Now that the NICs position generally follows what might be the expected route, there are no particular problems in practice. The lack of difficulties in practice are perhaps why we hardly heard anything about the subject during our evidence gathering. We have not heard reports that there is any real confusion, so have not considered this area in detail.

**4.7** From a simplification point of view, our instinct is that the term ‘office holder’ is outmoded and that any distinction between this and ‘employment’ should be abolished in the tax legislation. This would apply to income tax and NICs. The aim would be to ensure that there are no differences in tax/NICs treatment, now or in the future, for people who in reality are all employees in the everyday sense of the term.

**4.8** However, we are conscious that if there is no problem in practice with the operation of the term office holder, changing rules to abolish it would add to complexity – at least in the short

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<sup>121</sup> The definition was based on case law, including *Great Western Railway Company v Bater* (8 TC 231) and *Edwards v Clinch* (56 TC 367).

term – as it would cause change. It may well be that changes in recent years have dealt with any difficulties and the system operates smoothly and gets to the expected results.

**4.9** Accordingly, we would be interested in hearing from anyone who is experiencing particular problems in practice with the operation of the 'office holder' concept or who has experience of unexpected results arising from its application.

## 5 International comparisons

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**5.1** As part of our review the OTS looked at how a number of other countries tackle employment status and whether other countries have problems around correctly categorising individuals into employed or self-employed. During our work we looked at the tax systems in operation in around 20 countries. From initial surveys we looked in some depth at 11 countries' systems and details of the employment status related aspects are set out in Annex I. The countries covered in Annex I are a representative group that were selected to highlight the different categories of employment adopted across the world. This chapter draws out the key points and some potential lessons for the UK.

**5.2** We considered a number of factors:

- Different categories of employment
- Whether other countries have adopted a statutory employment test
- Tests used to determine employment status
- Different rates of tax for employed vs self-employed.

### Categories of employment

**5.3** In more than half of the countries looked at we found more than two categories of employment. The most common additional categories were independent contractor or freelancer. The definition of these two categories varies between countries, for example in Australia an 'independent contractor' can be a sole-trader or company. Quite often, additional categories of employment have been created partly to provide a level of employment rights which is not enjoyed by self-employed individuals without providing full rights associated with employment and could be seen as providing a half way between employed and self-employed.

**5.4** Certain countries adopt atypical categories of employment. For example, France was found to treat certain specialist skills as self-employed, e.g. lawyer, accountant, doctor. Luxembourg adopts the view that specific categories are employed. In Australia, there are some types of workers who are always employees: apprentices, trainees, company directors, labourers, trades assistants.

**5.5** The United Nations has also defined a classification of employment categories and groupings<sup>122</sup>:

- *Employers* run their own business, consistently hiring workers in an independent profession, sometimes with partners.
- *Own-account workers* run their own business but do not engage workers. They are remunerated for the work they undertake and are dependent upon this income. They make their own decisions regarding the company activity and are not employed in any continuous way.
- *Employees* work for employers and are paid for their work, have a contract of employment that is continuous and receive statutory benefits as well as paying relevant contributions.

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<sup>122</sup> <http://laborsta.ilo.org/applv8/data/icsee.html>

- *Unpaid family workers* provide services to a member of the same household, usually without receiving payment. They cannot be considered as a partner due to the level of involvement not being consistent with the individual running the business. This becomes a 'producers' co-operative' if there are significant numbers involved.
- *Members of producers' cooperatives* are individuals who operate in a self-employed capacity in a co-operative that provides a service for which each member of the co-operative is paid equally.
- *Persons not classifiable by status* are usually experienced workers whose work cannot be appropriately identified to signify status. It can also refer to the unemployed.

## Statutory employment tests

**5.6** Whilst undertaking the review of employment status we looked at whether other countries had adopted a statutory employment test. Our findings concluded no one country had adopted a full statutory test but many use a number of indicators (often built up from case law) to determine an individual's status. There are, however, a number of examples of countries that have adopted quasi-statutory tests to determine atypical groups, including Australia (withholding tax), Italy, the USA (ABC test) and Ireland (withholding tax).

### Australia

**5.7** In Australia, a business engaging a contractor is required to withhold Pay As You Go (similar to PAYE) tax if:

- the contractor does not quote their Australian business registration number to the business, in which case the business should withhold 49% from payments the business makes to the contractor; and
- the business enters into a voluntary agreement with the contractor to withhold tax from payments made to the contractor.

### Italy

**5.8** In Italy self-employed workers can claim their employment relationship has been misclassified and they should be considered subordinate employees if a series of indicators have been met, including stringent working time, fixed salary and subordination, which is legally proved when two of the following three circumstances occur:

- (i) The relationship lasts for more than eight months throughout two consecutive years
- (ii) The remuneration deriving from the relationship is more than 80% of the annual remuneration received by the worker throughout two consecutive years
- (iii) The worker is assigned their own permanent desk at the principal's office.

### United States

**5.9** In the USA the 'ABC' test applies. To be considered an independent contractor, an individual must meet all three of the following tests; the default is that the individual will be considered an employee:<sup>123</sup>

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<sup>123</sup> <https://www.ctdol.state.ct.us/uitax/abctest.doc>

#### **Box 5.A: The United States 'ABC' test for independent contractors**

- A The worker must be free from direction and control in the performance of the service, both under the contract of hire and in fact. (Essentially, this is the common law definition.)  
  
AND
- B The worker's services must be performed:  
  
EITHER  
  
(1) Outside the usual course of the employer's business  
  
OR  
  
(2) Outside all of the employer's places of business.  
  
AND
- C The worker must be customarily engaged in an independently established trade, occupation, profession or business of the same nature as the service being provided.

**5.10** It is worth remembering that some of these quasi-statutory tests could, on their own, be seen as relatively easy to manipulate and work around, hence the importance of having stringent requirements or a multi-layered approach. If the UK were to adopt a statutory employment test, consideration should therefore be given to the robustness of the measures developed. These areas are discussed further in Chapter 9.

### **Tests used to determine employment status**

**5.11** Our review looked at how particular countries determine employment status. In all the countries looked at it was found that tests are used to determine categories of employment.

**5.12** A number of countries use tests similar to those applied in the UK and in many cases the tests have evolved from case law rather than statute. The following list is not meant to be exhaustive but gives examples of the tests applied in the countries included in the review:

- Subordination to employer
- Dependency on one employer
- Control
- Financial risk i.e. fixed fee/hourly rate for work performed
- Ability to substitute
- Mutual obligation
- Behavioural control
- Regularity of remuneration
- Own materials
- Integration into the organisation



- Economic reality factors considered

**5.13** The Australian Taxation Office, for example, has two online employee/contractor decision tools for use to determine the status of an individual: one for the building and construction industry and a general employee/contractor decision tool. Having used the decision indicator tool for a number of examples we found it to be more user-friendly than the current version developed by HMRC.

**5.14** The main differences are around the general layout of screens, the user-friendly nature of how questions have been worded and the help option for each question which holds a significant amount of information, including examples to support a correct decision being made. Provided the responses accurately reflect the working arrangements the result provided by the decision tool can be relied upon. The Australian Tax Office say they will not charge a penalty that might otherwise apply. To help businesses comply, the Tax Office uses a combination of education and compliance measures.

**5.15** The review found a number of countries use 'subordination' as opposed to 'control' to determine employment status, whereas 'control' is used more within the UK legal cases to date.

## **Different rates of tax for employed vs self-employed**

**5.16** We looked at whether there is a correlation between types of employment and rates of tax in other countries. Evidence was taken from the OECD data which suggested that in countries where tax and NICs are more closely aligned there is a reduction in self-employment and the likelihood of people entering self-employment, and the duration of time people spend self-employed. The various tables within the OECD data suggest the UK's diminishing combined tax and social security rates, moving between employment to self-employment to incorporation, are not typical internationally.<sup>124</sup>

**5.17** A study reported in the 1992 OECD Employment Outlook suggested countries with a higher proportion of self-employment (Greece, Italy, Portugal and Spain) also tended to have higher employers' social security contributions.<sup>125</sup> This is also borne out by a more recent table published by OECD, an extract relating to some of the countries highlighted in the annex is given in Chart 5.A. below.<sup>126</sup>

**5.18** Clearly there will be other factors as to why individuals want to be categorised as engaged in a particular type of employment, such as industrial structure and employment rights associated with employment, to name a few.

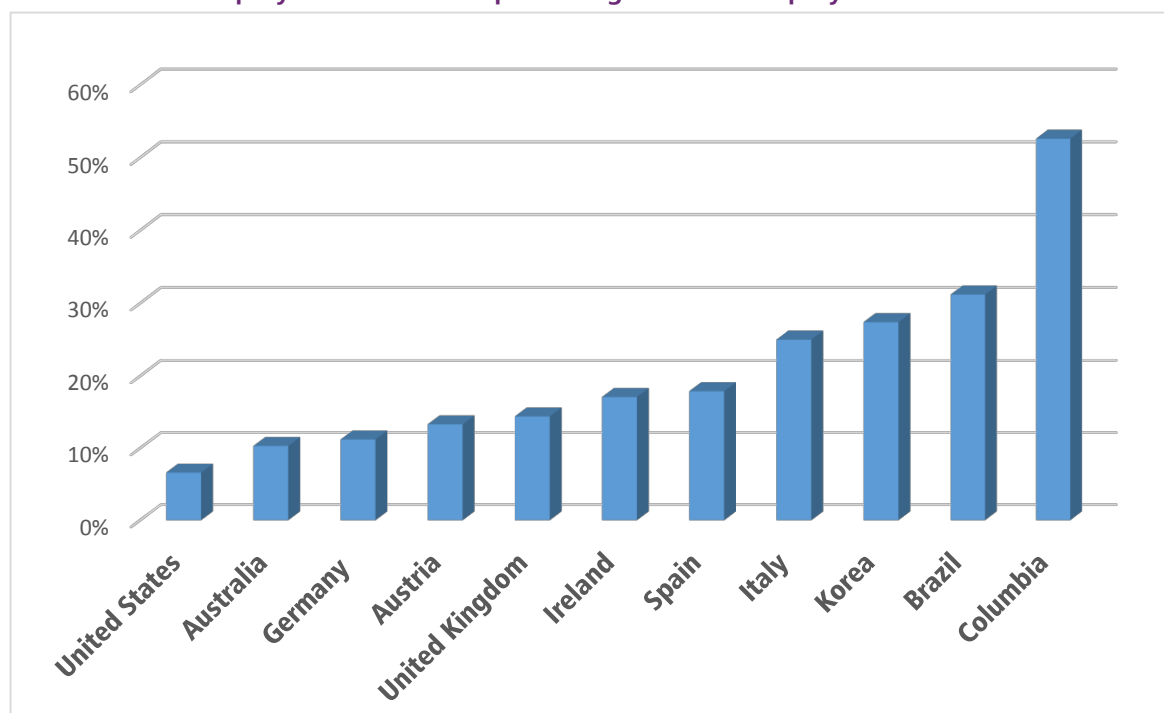
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<sup>124</sup> [http://www.oecd.org/ctp/tax-policy/Table%20II.3\\_Apr%202013.xlsx](http://www.oecd.org/ctp/tax-policy/Table%20II.3_Apr%202013.xlsx)

<sup>125</sup> <http://www.oecd.org/els/emp/2485491.pdf>

<sup>126</sup> <http://data.oecd.org/emp/self-employment-rate.htm>

**Chart 5.A: Self-employment rates as a percentage of total employment**



Source: OECD

## Comments from stakeholders

**5.19** As part of the OTS evidence gathering, we routinely asked about people’s experience of other countries’ systems in our meetings. This generated a fair number of comments, though many of the people we talked to admitted to having no real experience of other countries. There were no suggestions for countries that had ‘solved’ the problem of employment status and general agreement that all countries had the issue to a greater or lesser extent, though ways of managing it did differ. There was general consensus that it is difficult to see how there could be consistency across all countries.

### Some representative comments:

**5.20** Many countries appear to manage the position by ensuring that tax and social security are dealt with via self-assessment, or by withholding tax at source. *(Clients of Big 4 firm)*

**5.21** An attendee from a multi-national business commented that she had seen similar issues/challenges all over the world (South Africa and Belgium were given as particular examples where there is complexity).

**5.22** It was noted that countries who require all taxpayers to submit returns also take some of the pressure out of the system in that it increases likelihood of income being reported. *(Various)*

**5.23** It was felt that it would be difficult to introduce a solution for employment status issues that would bring consistency across all countries as what would work in the UK may not be appropriate in other areas. *(Clients of mid-tier firm)*

**5.24** Brazil was cited as an example of a country that had in effect side-stepped the problem – by not having differences in social security charges for employees/employers as against self-employed. *(Brazilian tax practitioner now practising in UK)*

**5.25** Examples including Norway were cited, where freelancers are treated as employees for tax and self-employed for employment law, and the Netherlands, where everyone in the employment supply chain is tax registered. (*Umbrella provider*)

## Conclusion

**5.26** The main categories of worker are employee, independent contractor, self-employed and agency worker. For some countries, e.g. Brazil and Colombia, outsourcing can give rise to complexities and it has been widely discussed in the legal arena. There are risks due to habitualness, exclusivity and subordination and arrangements need to be clearly identified to be seen as valid outsourcing. When this is the case the contracting company remains liable for the service provider's debts.

**5.27** Thresholds for income tax, pension and social security contributions vary from country to country but the employer generally contributes a larger proportion and many countries have a form of medical cover tax. One exception noted is that of Gibraltar where employees contribute 10% of gross salary as social insurance as opposed to the self-employed who contribute 20% of gross income.

**5.28** Seconded workers or those who are not legal citizens of the country normally continue to contribute to their home country system. Some countries (e.g. Colombia) have a ceiling on the amount to be paid, based on a multiplier of the minimum wage. In Australia, different rates of employment tax apply for employees and contractors and Pay as You Go, withholding, payroll tax and superannuation need to be considered. There is also an 80/20 rule in force which ensures sole traders and company director businesses are taxed in the same way as Pay as You Go employees (as indicated in Annex I).

**5.29** Ireland includes a Relevant Contracts Tax applied in the construction, forestry and meat processing industry for sub-contractors where tax is deducted at 35% unless a certificate is in place. Italy's most straightforward system relates to co-workers under a fixed-term contract who are included in the system and have tax deductions based on level of income and tax deductibles rather than a flat 20% withholding. These examples are discussed further in Chapter 11.

**5.30** Tests indicating status include control, conditions, remuneration, equipment provided, and whether individuals have their own business. All require a number of common law elements to be fulfilled in order to be categorised. The USA's ABC test clearly defines these specifics and has a more defined structure in that all three tests have to be met before contractor status is concluded (as noted in Annex I).

**5.31** Where there are tests in place, they can be complex and can take a considerable amount of time to get agreement with the relevant authorities and establish employment status. One needs to consider if this is an effective method and would argue the case for a simple, easily managed system to be put in place within the UK with strict criteria that cannot easily be worked around.

**5.32** The overall recommendation from our international studies and this chapter is that there are lessons from a number of other countries that can usefully be drawn on for the UK. The OTS has accordingly utilised the data in the later chapters of this report.

Part 2:

# Direct routes to improve the current situation

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## 6 Managing in practice

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**6.1** In common with our previous reports, we have heard from a wide range of individuals over the course of this review, including businesses (from large multinational organisations to small owner-managed businesses), tax advisers, representative bodies and HMRC frontline staff. We also conducted an on-line survey which had 340 respondents, whose views are summarised in Annex C.

**6.2** For some businesses, employment status is an issue that they face on a day-to-day basis, while for others it may arise relatively infrequently. We have heard a wide range of views from businesses, but whether the opinion expressed was that the issue of employment status is relatively straightforward or extremely complex, it is clear that the issue is something that is regarded as needing care and attention, and management in some form.

**6.3** Given the range of businesses that we have heard from over the course of this review, it is perhaps not surprising that different businesses have different capabilities in handling this issue. The largest businesses invariably have in-house specialist tax resources. Mid-sized and smaller businesses are unlikely to have such resources to any significant extent and therefore will tend to use external professional advisers. However, irrespective of the level of specialist tax resource and experience in dealing with employment status issues, this remains a difficult area for businesses of all sizes to manage.

### What drives an employment status decision?

**6.4** During the course of our review, we asked a range of businesses, agents, representative bodies and members of HMRC for their views on the drivers behind employment status decisions. In order to provide context as to how and why businesses manage the area of employment status in the manner in which they do, we have set out below a summary of the most common responses we had to this question (in no particular order):

- **Headcount** – for many businesses, a key performance indicator will be the headcount within that business. For example, in many large organisations, departments will often be judged (internally or externally) on measures such as “profit per head”. We therefore heard some examples of businesses preferring to engage a self-employed individual (usually via a limited company), or to obtain the services of agency workers, even though this may on occasion be more expensive than taking on another employee (taking into account the rates charged by self-employed individuals or the fees charged by an agency).
- **Flexibility** – this is a concept that is more relevant in some sectors than others, but many businesses find the flexibility to engage the services of self-employed individuals or agency workers at short notice to be a key part of their operations – workers are often engaged based on the business need at a given time. The process of taking on another employee can be a long process (from initially advertising the job, through the interview process and various other administrative processes, before the individual accepts the position and is finally added to the payroll), and is simply not feasible where a piece of work or project needs to be delivered within a short timeframe.

Businesses also outlined the difficulties faced by fluctuations in demand for labour (for example, there may be a commercial rationale for maintaining a certain level of employees to deliver projects, but the workforce may need to be supplemented by

additional workers if additional projects are won, or if an ongoing project slips behind schedule). In such situations, it is therefore critical for businesses to be able to engage self-employed individuals for short periods to undertake discrete pieces of work, without the administration of commencing and subsequently terminating an employment relationship.

- **Employment rights** – it was noted on many occasions during our project that the issue of employment rights is also a key factor in this area. Entering into an employee-employer relationship with an individual brings with it far more than simply an obligation to operate PAYE/NICs deductions. This includes the engaging business becoming liable to make statutory payments (such as holiday pay, statutory sick pay and statutory maternity/paternity pay), pay redundancy as well as taking on other obligations, including those relating to pensions auto-enrolment (noting that this is not only an issue for those individuals on a business's payroll – the definition of "worker" for these purposes means this is also an issue that can affect individuals who are not employees for tax purposes). For this reason, many businesses will prefer not to enter into employment relationships in all cases.<sup>127</sup>
- For completeness, it should be noted that we considered the possibility of workers being keen to be engaged on employed terms in order to acquire those employment rights. Whilst the businesses to whom we spoke in our review acknowledged this could potentially be a factor from the point of view of the individuals, it was something that most had rarely, if ever, seen in practice. However, it is a clear issue for those representing the low paid. The fear is that low paid workers are forced to take work 'off the payroll' as the only way of getting paid work and in doing so are made to sacrifice their employment rights/protection.
- **Employment tax and NICs cost** – from the point of view of an engaging business, in simple terms this cost will be secondary class 1 NICs (employers' NICs). These are currently charged at a rate of 13.8% on employees' earnings in excess of the secondary threshold (£7,956 annual equivalent for 2014/15). There is no equivalent levy on payments made to, amongst others, a self-employed individual, company or agency, although businesses did note on several occasions that agency fees and the rates charged by self-employed individuals will often mean that the amounts paid for these individuals' services will usually be higher than an equivalent employee's base salary. As a result, the difference in cost for the engaging business is often not as stark as the "headline" figure of 13.8% (although it is of course necessary to also consider the other additional costs of employment, such as the employment rights outlined above).
- **Tax risk** - whether this relates to the engagement of one self-employed individual, or a whole group of workers, the risk of HMRC potentially reviewing the arrangements in the future and seeking to reclassify the individuals as employees of the engaging business is a significant concern for businesses. To engage self-employed individuals and pay them on a gross basis carries with it the risk of HMRC disputing that treatment at some point in the future and pursuing PAYE/NICs across a number of tax years, together with interest and penalties.

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<sup>127</sup> As an example of the 'worst case scenario', one major employer cited an instance of a self-employed contractor they had used over a period of 20 years. Over that period both sides had paid tax on the basis that he was self-employed, a position accepted by HMRC. However, at the point when the business ceased to use the contractor, he started an action for redundancy. The case was settled before it came to court but it was seen as one where a real risk existed on employment law taking a very different route to tax law.

- **Reputational risk** - many businesses also noted that whilst tax risk is a key concern in this area, the reputational risks to a business faced with a major HMRC employment status review (both in relation to the individuals concerned, and in the wider marketplace) can be just as much of an issue. In addition, the time taken and resources required to deal with such a review also contribute to a position whereby many businesses are keen to minimise, or even remove entirely, the possibility of such a review by HMRC.
- Although not strictly relevant to the question of how businesses manage this issue in practice, it is worth noting that **from the point of view of the workers themselves, self-employment is also often seen as the more desirable manner of operation**. There are several reasons for this, including the difference in NICs paid by self-employed individuals (i.e. the rates of class 2 and 4 NICs paid by a self-employed individual, or the absence of any NICs on dividends paid out of a company, compared with primary class 1 NICs charged on an employee's earnings) and the ability to claim more expenses as a self-employed individual compared with an employee.

**6.5** It perhaps informs the debate to note that, on the basis of the people to whom we spoke during our review, there appears to be a significant gap between what HMRC officials and engaging businesses see as the drivers behind the manner in which the market approaches this issue. The view of HMRC staff often appears to be that the cost to the engaging businesses (and in particular, employers' NICs) is by far the main factor, whereas whilst businesses acknowledge that this is a factor, commercial factors such as headcount, flexibility and risk management are often of much greater importance when considering how to manage this issue.

**6.6** It is also worthy of note that when a business identifies a need for some form of resource, the commercial decision on whether that resource should be engaged on an employed or contracted basis will often be very straightforward (with businesses being clear on when it makes commercial sense to take on another employee, and when contracting is the more suitable option). Many businesses feel that it is only when also considering the tax position that the issue becomes much more unclear and an element of risk is introduced.

## Difficulties encountered by businesses in relation to employment status

**6.7** During our various meetings with businesses over the course of this review, a common reason for the difficulties in managing this area was stated to be the **lack of clarity and certainty**. In particular, the lack of specific legislation which categorically determines status means that businesses are often required to interpret existing case law and HMRC guidance, and seek to apply those cases and guidance to their specific situation.

**6.8** One particular problem that this presents is that much of the case law and guidance is considered to lag behind modern working practices and the scenarios that businesses currently see in practice. For example, there are obvious difficulties in seeking to apply the same cases relating to supervision, direction and control to individuals working in the professional services sector compared with individuals working in a manual labour role, and it is considered that these difficulties are exacerbated by increased mechanisation and digitisation – in short, the way in which people work nowadays is often very different from the way in which they worked at the time that cases were decided and/or HMRC guidance published.

**6.9** We also heard on a number of occasions that the differing tests and interpretations of what constitutes an employee for the purposes of tax, employment law and pensions auto-enrolment



amongst others also gives rise to difficulties, leading to regular comments that consistent definitions across all areas could be a useful step towards greater clarity and certainty.

**6.10** The lack of certainty in this area means that a business can never be absolutely confident that HMRC will not seek to review the arrangements in the future, and possibly reach a different conclusion. Even in situations where the risk of HMRC successfully challenging the treatment of payments to self-employed individuals is considered to be low, the potential PAYE/NICs, interest and penalties at stake, should HMRC reclassify the individuals as employees for tax purposes (“the worst case scenario”) is often a significant figure (particularly when applied across a number of years). It can be a major stumbling block in corporate transactions. Anecdotally, we were made aware of a number of corporate transactions being significantly delayed, or in some cases aborted, due to the lack of clarity in this area – the position was, in some cases, too much of a grey area for potential purchasers/investors to be sufficiently comfortable with the level of risk, resulting in them choosing not to go ahead with their proposed investments.

## Other difficulties raised by businesses

**6.11** The employment status of a particular individual may change over time. For example, an individual may be engaged in order to undertake a discrete project (which, depending on the circumstances, may be properly considered to be on a self-employed basis at the outset). But over time the nature of the relationship may change, either due to the scope of the project expanding, or the individual becoming involved in other areas of the business. In such circumstances, it can be difficult to judge the point at which an individual “crosses the line” from self-employment to employment.

**6.12** There is not a consistent and high level of knowledge of status issues within and across organisations. Within a business with little employment tax expertise, there may be a lack of awareness of the manner in which HMRC approach and view this issue, and a lack of understanding of the potential ramifications of incorrectly classifying a worker’s employment status.

**6.13** Within larger businesses, our discussions highlighted that individuals with relatively little employment tax knowledge or experience may make a decision to engage a self-employed individual, and may agree to the terms of payment before members of the finance or specialist in-house tax teams are even aware of the nature of the arrangements. In the case of very short term arrangements, payments may even have been made on a gross basis without comment or input from those finance teams. Such scenarios can inadvertently leave a business with a potential employment status risk (and in some cases, the need to consider whether a voluntary disclosure ought to be made to HMRC).

**6.14** It was also noted that there can often be difficulties around small payments being made to individuals (for example, £50 for running a workshop/lecture at a university, or a single day’s engagement of a driver by a haulage firm). If these payments are infrequent, then it can be an administrative burden to process the income via payroll.

**6.15** This issue led to discussion as to whether there could be an acceptable de minimis level of payment or period of time for which the individual is providing services for which the engaging business would not need to consider employment status, and payroll obligations simply would not be a concern, much like the ‘seven day’ rule mentioned in Chapter 3<sup>128</sup>. Any legislation or guidance in this area would clearly require careful drafting (for example, to avoid individuals

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<sup>128</sup> The 7 day rule applies to those in the film & TV industry and to income tax only – see chapter 3

receiving a series of payments below a 'de minimis' level, under separate contracts but which are, in reality, connected or relating to a continuous engagement).

**6.16** If a position could be reached whereby businesses could be comfortable that they did not need to worry about employment status for certain payments, this could be a useful simplification and allow businesses to concentrate on a smaller number of cases, where a material issue may arise.

**6.17** This does still leave the question of how tax and NICs would be accounted for on the income. To address this issue, some of the people to whom we spoke also proposed the introduction of some sort of mechanism for engagers to report such income to HMRC. Individuals already within self-assessment could then account for any tax or NICs in the normal manner, by entering the income on their self-assessment tax returns. For those individuals not already within the self-assessment regime, it seems a disproportionately large administrative burden to register for self-assessment and/or prepare self-assessment tax returns to report such small amounts of income. Therefore, for those individuals who may only be in receipt of a small number of insubstantial payments, HMRC, having received details of the amounts received by the individual in the year, could raise assessments for the tax, or (if the individual also has a PAYE income source) include a restriction in their tax code.

**6.18** Although this seems to be a significant increase in reporting burdens, businesses did not see it that way. Most felt that it would be a simple extension to RTI, with a requirement to report payments against an individual's NINO. There would be a burden for HMRC to administer and match up the payments, but all of these discussions were on the basis that improvements in IT would mean a much more digitally-enabled system that could accordingly give better results all round.

**6.19** Taking this a step further, there was also discussion around the possibility of businesses reporting all payments made to self-employed individuals, possibly with some form of associated tax deduction. This is considered in more detail in Chapter 11 of this report.

## **Tax risk – is this fairly distributed?**

**6.20** Whilst talking to businesses and asking them why they decide to manage employment status in the way in which they do, one of the common themes was the way in which the tax risk is positioned. As outlined above, if a business makes payments to self-employed individuals on a gross basis and they are subsequently reclassified by HMRC as employees for tax purposes, the business that has made the payments is likely to receive a demand for PAYE and Class 1 NICs (both primary and secondary contributions), together with interest and penalties across a number of years.

**6.21** Whilst the PAYE regulations do provide for amounts paid by the individuals under self-assessment to be offset against the liabilities HMRC would otherwise levy on the engaging business, there is no automatic right to this offset. Furthermore, in the event that the self-employed individuals have not actually declared the income and paid any tax and/or NICs thereon, the PAYE and class 1 NICs liabilities will rest with the engaging business.

**6.22** This situation arises due to the PAYE regulations placing the obligation on the engaging business to operate PAYE in appropriate circumstances. Another implication of this obligation is that during the course of HMRC employer compliance reviews, HMRC expect the engaging business to have considered employment status matters in detail and to have been confident that the correct tax treatment was being applied before making any such payments.

**6.23** Whilst it is undoubtedly correct that a business should shoulder some of the responsibility in ensuring that PAYE and class 1 NICs are accounted for whenever appropriate (and this is a

concept with which businesses were in agreement during our discussions), there was also a strong feeling amongst those businesses they should not carry the sole responsibility, and that this should be shared, at least in part, with the self-employed individuals themselves. This contrasts with some of the views we heard from HMRC (which are discussed further below), but the current situation does help to explain why businesses take their current approach to the management of employment status risk.

## What actions are therefore taken?<sup>129</sup>

**6.24** The result of all of the above difficulties is that businesses often feel that employment status represents a disproportionately large risk from an employment tax and reputational perspective.

**6.25** In order to minimise or remove this risk, as well as deal with some of the other drivers outlined above, many businesses told us they would never engage directly with self-employed individuals and pay them gross, and instead would take one, or a combination, of the following actions:

- Pay all self-employed individuals via payroll, with PAYE and class 1 NICs operated accordingly (often seen as the prudent approach, with no risk of HMRC seeking to reclassify the employment status of the individuals).
- Only engage with self-employed individuals who operate via their own limited companies (or similar corporate entity). In such scenarios, the engaging business is protected from any challenge from HMRC in relation to the employment status of the individuals (other than in the case of office holders operating via a limited company) as a result of the IR35 legislation. Such actions, of course, do not remove the employment status issue from the particular situation, but the IR35 legislation transfers the potential PAYE/NICs obligation from the engaging business to the limited company, and, as such, removes the employment status tax risk from the engaging business.
- Engage directly with an agency for the provision of workers, the result of which being that, in the vast majority of cases, the business will pay an agreed rate to the agency (usually upon receipt of a VAT invoice from the agency), who will pay the individuals and operate PAYE/NICs as appropriate.

**6.26** However, such actions are often the least appropriate solution to the problem, and are viewed by many businesses as the ‘tail wagging the dog’ and inevitably result in increased costs for businesses.

**6.27** As noted above, one of the actions many businesses take to manage their employment status risk is to only engage with self-employed individuals who operate via their own limited companies. In many cases, this means that businesses engage with limited companies which are already in existence, in order to access the services provided by the individual(s) within those limited companies.

**6.28** However, we were told on several occasions that a business will require individuals operating as sole traders/self-employed individuals to incorporate, so that the business can contract directly with the individual’s limited company and manage its employment status risk. If the individual is unwilling to take such action, this often means that they will not be engaged to undertake the work. The result of such an approach by engagers appears to be that many

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<sup>129</sup> We were attracted to one response, from someone working as a freelancer, to the question of how the uncertainties around employment status are managed in practice: “...2 large scotches a night”!

individuals are forced to incorporate in order to obtain work and earn a living, even though they have no real desire to operate in this manner, and quite often do not understand what obligations this places upon them (in relation to, for example, preparation of accounts, filings with Companies House, submission of corporation tax returns and payment of corporation tax liabilities).

**6.29** Anecdotally, we were told by several businesses that they are aware of competitors within their industry being prepared to ‘take the risk’ of HMRC reviewing the position in the future (a risk they consider to be low given HMRC’s perceived lack of resource in policing the issue). Some businesses told us that they would take on individuals as employees and operate PAYE and NICs deductions, either because they felt that the individuals were properly categorised as employees, or that the position was a grey area and the prudent action was to treat them as such. However, some businesses felt that this left them at a competitive disadvantage compared with those competitors who take a less rigorous attitude to this issue.

**6.30** However, whilst one or more of the actions outlined above are taken by many businesses, this is far from the complete picture. Many businesses do engage individuals on a self-employed basis and, whilst it is probably fair to say that some businesses do this without necessarily considering employment status issues, many more businesses do take steps to ensure the appropriate employment status is applied. This may often involve the use of HMRC’s published guidance, use of the Employment Status Indicator tool on HMRC’s website, direct correspondence with HMRC, taking professional advice, or a combination of some or all of these options.

**6.31** During our various meetings with businesses and advisers over the course of this review, we have sought views on the information that is currently available in this area, and have also discussed this topic with various members of HMRC. We have set out our findings in the following two chapters, together with various recommendations on how the information might be developed or enhanced.

## Conclusion

**6.32** The main recommendation from this chapter is that the idea of a set de minimis level for payments to an individual who carries out some activities for a business, which would definitely not be an employment, should be explored. This might be in terms of time spent or payments made and could link to the withholding tax idea discussed in Chapter 11.



## 7 HMRC administration

**7.1** Having considered the points raised during our discussions with businesses in relation to how they currently seek to manage this issue, it is also important to consider HMRC's practical experiences in this area and the way in which businesses and HMRC interact over this issue, as well as look at the information that HMRC already makes available to taxpayers in this area:

### **Box 7.A: HMRC guidance on employment status**

#### **Employment Status Manual – (HMRC)**

(<http://www.hmrc.gov.uk/manuals/esmmanual/Index.htm>)

HMRC's Employment Status Manual is intended to provide guidance on issues relating to the employment status of individuals. It is a comprehensive manual but is guidance for HMRC staff, tax agents and advisers, and as such is not suitable for the lay person.

#### **Employment Status – (gov.uk) (<https://www.gov.uk/employment-status>)**

Guide covering worker, employee, self-employed and contractor, director and office holder. This is a basic guide for the lay person and focuses on employment rights, and not tax.

#### **Employed or Self-Employed (Business Tax – collection (gov.uk) – (first published 26 November 2014) (<https://www.gov.uk/government/collections/employed-or-self-employed>)**

A new collection of guidance on employment status for the purposes of tax and NICs. It includes the Employment Status Manual, the Employment Status Indicator Tool, IR35, status and employment agencies (employment intermediaries: reporting requirements). This guidance is aimed at the business user and is not suitable for the layman.

#### **HMRC YouTube Channel - <https://www.youtube.com/watch?v=Als7oyi5slg>**

'Self-employment and HMRC - what you need to know' – this focuses on what the self-employed need to do in order to meet their tax and NICs obligations, and also gives a description of some of the tax reliefs they may be able to claim, but does not cover employment status.

#### **Thinking of working for yourself (SE1) (<https://www.gov.uk/government/publications/setting-up-in-business-se1>)**

This is a basic booklet produced by HMRC for the layperson. It sets out the choices of 'self-employment' but there is no mention of employment status issues

#### **The Employment Status Indicator (ESI) tool**

This is discussed in more detail in Chapter 8.

In addition, HMRC did have a leaflet to explain how to decide if you were employed or self-employed, although it appears to only be available via the National Archives.

**7.2** The OTS has received a lot of feedback from its survey and comments in meetings that there needs to be more information on employment status and the information needs to be written for the lay person. As is clear from Box 7.A. above, HMRC provides information on employment status but it is often not well signposted and, according to feedback, needs more clarity.

**7.3** The above comments, together with some of the points which follow should not be taken to mean that feedback on these information sources was wholly negative. The OTS received various items of feedback stating that HMRC guidance and information was useful and comprehensive. However, the general feeling is that the information provided often requires too much background knowledge of the area, and is not easily accessible to the lay person. We also heard that the information is not always easy to find (and in many cases, the user must know exactly what they are looking for in order to find it), and this problem has been exacerbated since the transfer of information to the gov.uk website.

**7.4** Possible enhancements and additions to the actual information provided are discussed in some detail in this Chapter, but as an overall comment, **the OTS considers that all of the relevant material should be brought together in some form of “employment status portal”, covering both tax and employment rights.**

## Documenting an employment status decision

**7.5** As noted already in Chapter 6, businesses regularly told us that they feel the tax risks are unfairly allocated between the engager and the individuals, requiring businesses to undertake too many actions in order to demonstrate that they have given due consideration to the issue before engaging and paying a self-employed individual. The view from many businesses is that more responsibility for determining the position should be placed on the shoulders of the individual.

**7.6** It is therefore interesting to note that in HMRC’s experience, compliance officers often find that businesses have made broad assumptions in this area. For example, if engaging an individual on a flexible or non-permanent role, the assumption often seems to be made that the individual is automatically self-employed (this was the perspective offered by a number of HMRC staff members to whom we spoke). We were also informed that HMRC officers regularly see instances of workers informing a business that they are self-employed, and the engaging business then takes no further action to consider the employment status position.

**7.7** Furthermore, during the course of employment status reviews, HMRC compliance officers often find that there is no documentation or ‘footprint’ behind a business’ decision to classify an individual as self-employed. Where HMRC reclassify self-employed individuals as employees of a business, this situation inevitably leads to protracted disputes between HMRC and businesses (and, often, their agents) around the behaviours at play, which in turn has an impact on the penalty position during the course of a settlement.

**7.8** The contrasting views put forward by businesses and HMRC raise the question of whether further guidance ought to be issued, setting out the types of documentation and actions that HMRC would expect to see a business take when engaging a self-employed individual (in effect, a document setting out ‘what good looks like’). This would be of particular use to businesses given that employment status can be such a subjective area, and it seems that there would be several benefits of such guidance being introduced:

- It would ensure that businesses know what actions they should be taking at the outset when engaging an individual to undertake some work for them, which may in turn help to ensure that the correct employment status is applied from the outset.
- Businesses should be better able to manage their risk in this area, as they would have a clear understanding of the actions that HMRC expect them to take.
- In the case of any future HMRC reviews, if businesses have followed the guidance, they should be able to much more readily demonstrate their thought process behind the



decision to engage a self-employed individual in the manner in which they did. This should result in these reviews being less protracted, particularly in relation to negotiations around any penalties which HMRC may seek to levy.

**7.9** By way of an international comparison, France takes a hard line on employers who misclassify an employee either mistakenly or deliberately. For failure to make the statutory prior registration of a new employee (*'déclaration préalable à l'embauche'*), the employer can be fined in the region of €1,500. Where the work is 'knowingly' undeclared (*'travail dissimulé'*) the fine is in the region of €45,000 and this may include imprisonment of up to three years.<sup>130</sup>

## Interactions between businesses and HMRC

**7.10** During our discussions with businesses, we asked for views on their dealings with HMRC in relation to employment status (including compliance reviews, helplines and guidance and publications).

**7.11** A common theme was that businesses would not tend to approach HMRC for an opinion on an employment status issue, typically because they felt that HMRC would invariably state that the individual concerned should be treated as an employee for tax purposes. Some would use internal resources (often carefully developed guidance material); others would involve external advisers.

**7.12** A further problem noted was that whilst it is best practice to assess the contract and consider employment status at the outset of an engagement, there is a feeling from businesses that any interaction with HMRC on a complex, subjective issue could take weeks or even months to resolve. For that reason, they would tend not to approach HMRC for a ruling. A suggestion put forward by one person to whom we spoke is that individuals could be paid via payroll until such a clearance has been received, although such an approach is likely to be strongly resisted by businesses and the feasibility of this suggestion would need to be considered in detail.

## Approaching HMRC for a ruling

**7.13** Whilst acknowledging that the businesses to whom we spoke would be reluctant to approach HMRC for a ruling, it should nonetheless be noted that there is a mechanism for doing so, should businesses wish to use it.

**7.14** One option for businesses could be to use the Employment Status Indicator tool, and this is considered in more detail in Chapter 8. However, the business may prefer to use HMRC's Customer Service Team rather than the Employment Status Indicator tool. The Customer Service team can give a written 'status opinion', and will review documents and the contractual arrangements and may talk to the engager. The team are advised to use the Employment Status Indicator tool, but if they are having difficulty operating the tool they are advised to consult:

- HMRC's Specialist Employer Compliance team, or
- The status inspector in Large Business Service cases

**7.15** A referral to the Specialist Employer Compliance team<sup>131</sup> will be appropriate where during the course of a compliance check a technical issue arises and guidance is not readily accessible in existing internal publications or cannot be supplied within the team. The nature of a referral may vary dependent upon the experience of individual teams.

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<sup>130</sup> Philippe Despres France: The Independent Worker and Employee Status [2006]

<sup>131</sup> COG 904550 - Supporting Guidance: employer compliance: guidance by subject: liaison: specialist employer compliance (SEC) - when to make a referral



**7.16** HMRC's internal guidance states that mandatory referrals should be made to the Specialist Employer Compliance team where:

- an informal or Employment Status Indicator opinion has been disputed (although there may well have been earlier contact with the Status Inspector or Status Support Officer)<sup>132</sup>
- the customer disputes the liability on a technical employment issue which is likely to result in formal assessment
- submissions to the PAYE, SA & NICs group (PSN) are required

**7.17** Where a taxpayer has given full and honest information regarding an engagement and HMRC have previously given incorrect advice regarding the employment status of the engagement, then it would be difficult for HMRC to justify seeking retrospective recovery.<sup>133</sup>

**7.18** A common theme amongst businesses and their representatives was that there was no certainty on issues of employment status. A business could not approach HMRC and get a binding decision as to the status of their workers. Other comments centred on the procedure and that it was a lengthy process that could take months or years to reach a conclusion.

**7.19** There is considerable merit in the idea of a 'safe harbour' basis that balances businesses' need for certainty with the risk to HMRC. We recommend that further work is carried out on the idea and how it might be developed.

## Binding nature of a status opinion

**7.20** It should be noted that the 'status opinion' outlined above is not a formal decision and carries no right of appeal<sup>134</sup>. The opinion applies to both NICs and income tax, unless it is made clear otherwise and HMRC will be bound by the opinion, if it is not disputed<sup>135</sup>.

**7.21** If the status opinion is disputed, then HMRC will have to give a formal decision against it which the customer can appeal and HMRC will also consider giving a determination. The dispute can then escalate to the First Tier Tribunal and Upper Tribunal.

**7.22** People who ask for an opinion on status are entitled to an answer they can rely on<sup>136</sup>. So any previous opinion given in writing is binding except where it can be shown that the information provided was misleading and/or incorrect; or the facts have changed materially since any previous opinion was given.

**7.23** HMRC are not bound on the status of an individual simply on the basis that they have, for example:

- registered for VAT
- made returns assuming self-employment
- applied and been accepted to pay self-employed NICs, or
- received a decision from an employment tribunal.

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<sup>132</sup> COG 907600

<sup>133</sup> COG 907630 - Supporting Guidance: employer compliance: guidance by subject: status: recovery for earlier years: exceptions to general approach

<sup>134</sup> ESM 0106 - Procedural aspects of status cases: written decisions and opinions

<sup>135</sup> ESM 0107 - Procedural aspects of status cases: actual cases - what to do when you have formed an opinion

<sup>136</sup> ESM 0111 - Procedural aspects of status cases: binding nature of opinions in writing.

**7.24** An officer of HMRC has the right to determine<sup>137</sup> employment status with reference to the category of earner, for a claim for industrial injury<sup>138</sup> or statutory payments dispute<sup>139</sup>. There is a right to appeal the decision.

**7.25** The fact that HMRC cannot be bound by the sort of situations noted above was accepted in the meetings we held because people accepted that HMRC must have protection against being given wrong or incomplete information. But serious doubts were raised about the fairness of a system that allows someone to be treated as self-employed for many purposes but then be faced with a different status for income tax.

**7.26** What many sought was some form of ‘safe harbour’: a regular suggestion was that HMRC should in such circumstances be allowed to give a ruling on status to apply from the date of the ruling, but could not apply it retrospectively if it meant going against evidence such as VAT registration being accepted by HMRC. We think this is an issue that needs to be explored further and would welcome HMRC’s comments.

## Other alternatives available to businesses

**7.27** However, on the basis that they would tend not to approach HMRC for a ruling, businesses will therefore seek to either make the decision themselves (possibly by making reference to HMRC guidance and publications, but less often by reference to the Employment Status Indicator tool, for the reasons outlined in Chapter 8 below), or may take professional advice on the matter.

**7.28** We raised the possibility of businesses using HMRC’s helplines, if not to discuss the engagement of a particular individual, then possibly with a more general query around employment status. Many of the comments we received in this area were similar to those made in the OTS’s “Review of the competitiveness of the UK Tax administration”<sup>140</sup> which we will not repeat here. However, with specific reference to employment status, it was felt that calling HMRC’s employers’ helpline was of limited assistance for anything other than a generic or straightforward question (the answer to which could probably be readily found within published guidance).

**7.29** A number of individuals raised the possibility of a specialist employment status helpline being established, where businesses are able to discuss specific queries with an HMRC officer with specialist knowledge of the subject. Whilst this raises further questions in relation to resource, and the possible requirement for more HMRC officers to undertake specialist training in the area of employment status, this suggestion certainly does appear to have some merit, particularly if it were to encourage businesses to interact with HMRC on this complex subject, and may reduce the amount of time that businesses need to devote to considering employment status issues. It might also save HMRC time in the long run. **Furthermore, this suggestion would fit neatly with the ‘once and done’ approach which HMRC is keen to develop<sup>141</sup>.**

**7.30** As previously noted, businesses, professional advisers and representative bodies often told us that they found HMRC guidance and publications to be out of date, and that they did not keep pace with developments in working practices. In particular, the opinion was often expressed that there were very few examples which could be easily applied to some of the most common professions and practices seen in today’s marketplace (such as the increasing

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<sup>137</sup> Section 8 of the Social Security Contributions (Transfer of Functions, etc.) Act 1999

<sup>138</sup> DANSP 15400 - Decision types: Employment status decisions: Introduction

<sup>139</sup> DANSP 15500 - Decision types: Employment status decisions: Statutory payments dispute

<sup>140</sup> <https://www.gov.uk/government/publications/competitiveness-of-uk-tax-administration-review>

<sup>141</sup> HMRC Business Plan: 2014 to 2016, April 2014. <https://www.gov.uk/government/publications/hmrcs-business-plan-2014-to-2016/hmrc-business-plan-2014-to-2016>

prevalence of remote working). **Many businesses felt that they would place more emphasis and reliance on the guidance and publications if they contained more 'real life' examples, together with details of how the employment status principles that have been established by case law would apply to those examples.**

**7.31** Although an issue that is arguably addressed by the 'particular occupations' section of the Employment Status Manual, businesses and professional advisers did indicate that they would value the introduction of additional guidance to cover the most common groups of workers for whom employment status is an issue. This, in turn, may only leave a small number of activities for which the position is less clear. As outlined in Chapter 3, there is already information on a number of specific professions within the Employment Status Manual. **Therefore, the fact that this point was raised during our discussions suggests that the Employment Status Manual could perhaps benefit from certain improvements in order to encourage its use by businesses.**

## **HMRC employment status reviews**

**7.32** For the reasons outlined above, businesses are generally quite reluctant to approach HMRC for an opinion on an employment status issue. It therefore seems that the most common occasion on which businesses and HMRC would engage directly on this issue is during an HMRC employer compliance review, or aspect enquiry into employment status issues.

**7.33** We discussed this area with businesses who had been the subject of such a review or enquiry, as well as with various HMRC staff members (including senior HMRC officers specialising in employment status, as well as members of HMRC compliance teams who regularly visit businesses to undertake the reviews).

**7.34** A common theme during our discussions with these parties is that, other than in the most straightforward of cases, such reviews can be very time consuming and costly.

**7.35** In the case of a general HMRC employer compliance review (which will encompass a wide range of employment tax issues, rather than simply employment status), the OTS has been told by agents and businesses that it is often the case that the HMRC officers undertaking the review will not be specialists in employment status cases. A number of businesses and their advisers told us that this can result in the initial 'fact-find' into the employment status issue being undertaken by a non-specialist, and then relaying the information gathered to an appropriate specialist within the wider HMRC team. Such practices leave scope for certain important points to be misinterpreted. We were told that in many instances that this can result in HMRC issuing written decisions, reclassifying self-employed individuals as employees of the businesses, with these decisions often being overturned following an appeal or further review. The result is a protracted review with little or no tax and NICs settlement.

**7.36** As noted, various HMRC staff members with whom we spoke during this project said that they often found reviews into employment status issues to be very time consuming. Whilst this is not necessarily surprising given the complexities of the area, one of the main reasons given is that professional advisers often wish to deal with such matters via correspondence, rather than via face-to-face meetings. Many HMRC staff members (specialising in employment status) noted that they would much prefer to undertake such reviews via meetings, as this is usually the best forum to fact-find, and what would otherwise take several months of correspondence can often be covered during a two hour meeting.

**7.37** These two observations point towards the need for additional HMRC resources to be allocated to the subject of employment status, specifically the need for more HMRC staff to receive specialist training in this area. This may lead to many employment status reviews and enquiries being far less protracted in the future, as the specialist HMRC staff may be able to

definitively establish whether or not there is an issue to consider during their initial fact-find, and businesses and advisers may be more amenable to accepting face-to-face meetings with HMRC.

**7.38** We were also informed by representatives of industry bodies that it is not uncommon for employment status disputes to be resolved via some form of negotiation, and as a result there can be a lack of consistency around how each dispute is settled. This can cause difficulties for representative bodies who become aware of certain members who have reached some agreement with HMRC, which is not consistent with that applied to other members in the same industry.

**7.39** Although noting that a lack of consistency can be an issue in relation to negotiated settlements (and this is not simply confined to the issue of employment status), the OTS acknowledges that this is, to a certain extent, unavoidable, and in complex cases there will always be a need for both parties to be pragmatic in their approach to resolving a dispute. However, it would be desirable to keep the number of such instances to a minimum, something which it is felt could partly be achieved by taking forward some of the recommendations outlined above, including the improvements to the existing guidance in this area.

## HMRC resource and enforcement

**7.40** The subject of HMRC resource in policing the issue of employment status is another issue which was regularly brought to the attention of the OTS during our various meetings on this project. As noted in Chapter 6, a number of businesses informed us that they take on individuals as employees and operate PAYE and NICs deductions accordingly (either because they feel this is the appropriate treatment, or that they consider this to be the prudent approach given the risks and uncertainties in this area), but consider themselves to be at a competitive disadvantage compared with those competitors who take a less rigorous attitude to this issue.

**7.41** Clearly much of this is based on conjecture and the perception of businesses, as the basic principles of confidentiality will dictate that HMRC would not disclose to a business whether it was also undertaking reviews of its competitors (although HMRC do publicise initiatives that it is running in relation to certain industries). However, given that this feeling does exist amongst many of the businesses we met with during this review (and is also a feeling shared by a number of other people with whom we spoke, including advisers and individuals from representative bodies), it does seem that this is an issue which could benefit from further HMRC action.

**7.42** This may involve HMRC increasing awareness of the reviews it undertakes in relation to employment status, or the devotion of increased resource to this issue, or a combination of the two, the key being to tackle the perception that seems to exist in the marketplace regarding HMRC enforcement around employment status. The OTS acknowledges that HMRC resource is not an issue that is unique to the subject of employment status. However, the way in which businesses approach this subject can lead to practices becoming established within whole sectors and industries, and **the OTS therefore considers that employment status should be high on HMRC's list of priorities when deciding how to best allocate any additional resources.**

**7.43** Another facet of HMRC enforcement that was brought up in a number of meetings is the position of agreements HMRC have reached with particular sectors. We have referred to some of these in Chapter 3 and for ease of reference repeat below our recommendation. The concern expressed by those who raised the issue was that HMRC have given up in certain areas; have accepted (usually) self-employment status in sectors where the facts did not support anything other than employed status. Two general examples raised with us were in forestry and scaffolding. As an example of a specific situation, one submission from an individual working in the film industry explained his annoyance at finding that although he was a freelancer, working widely in different roles, he would be classed as an employee at times; he commented that:

*"It seems like HMRC have abdicated their responsibility to [union guidance]"*

**7.44** The easements and concessions discussed above generally make the tax system simpler for those involved. In principle, the OTS has to support them. However, they do raise issues of fairness (should they be available more widely? Are they fair to the general body of taxpayers?). Assuming HMRC are satisfied they are a fair use of their administrative powers, the OTS considers that if the easements and concessions set out in the above paragraphs are to be continued with, they should be formalised in Statements of Practice and given proper publicity. Particular grading lists and the basis of the agreements should be fully set out within the HMRC guidance. These arrangements should be consistent for both tax and national insurance purposes.

## **IR35 administration review**

**7.45** The OTS have not included IR35 in this review because, as previously mentioned, HMRC's IR35 Forum have just released their report of the administration of IR35<sup>142</sup>. Many of the recommendations in the IR35 report<sup>143</sup> are centred on 'targeted communications' and providing a specialist helpline. It would seem pertinent, then, to explore if there is any synergy between the recommendations for IR35 purposes and those of the OTS under this employment status review.

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<sup>142</sup> IR35 Forum Administration Review – released 5 January 2015 <https://www.gov.uk/government/publications/ir35-forum-administration-review-final-report>

<sup>143</sup> IR35 Forum Administration Review - Annex D Recommendations

# Employment status

## 8 indicator tool

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**8.1** In considering how to simplify employment status, it seemed pertinent to look at what we already have available and whether it is fit for purpose. One of the tools available is the Employment Status Indicator (ESI) tool provided by HMRC. The OTS considered that it was worth exploring the efficacy and efficiency of the tool and whether it serves the purpose for which it was designed. This part of our work included our own research into how the tool is structured, as well as discussing the tool with businesses, advisers, and members of HMRC in order to obtain their thoughts on how the tool currently operates, and how, if at all, it might be enhanced.

### ESI tool online

**8.2** The Employment Status Indicator (ESI) tool allows the user to check the employment status of an individual or group of workers, that is, whether they are employed or self-employed for tax, NICs or VAT purposes<sup>144</sup>. The ESI tool will provide an opinion on the status of workers or a group of workers by using information that reflects the facts of the engagement. HMRC advise people to fact-find where status is in doubt<sup>145</sup>, but once the fact finding has been carried out, the ESI tool must be used by the status inspector, except in the following circumstances:

- Personal service company workers
- Agency workers
- Entertainers or workers in the TV and film industries
- Office holders (such as company directors and certain other individuals who are appointed to a post)<sup>146</sup>.

**8.3** The ESI tool is anonymous, but will provide an 'indication' of the worker's employment status, either as employed, self-employed or not determined. The ESI outcome can be relied upon as evidence of a worker's status for tax/NICs and VAT purposes if both of the following apply:

- the answers to the ESI questions accurately reflect the terms and conditions under which the worker provides their services
- the ESI has been completed by an engager or their authorised representative (whereas if a worker completes the ESI tool the result is only indicative)

**8.4** A copy of the 'Enquiry Details' screen and the 'ESI Result screen' must be saved and printed, bearing the ESI reference generated by the software. If the worker's employment status is questioned in the future, HMRC will only be bound by the ESI outcome if these copies can be produced<sup>147</sup>.

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<sup>144</sup> COG 907520 - Supporting Guidance: employer compliance: guidance by subject: status: the employment status indicator tool

<sup>145</sup> ESM 0558 - Guide to determining status: fact finding/evidence gathering

<sup>146</sup> It is hoped by HMRC that agency workers and personal service companies can be added to the ESI this year (2015), also some TV and film workers, but not all e.g. camera workers

<sup>147</sup> In the updated version, this will be produced in a .pdf

## Employment status case law reflected in the ESI

**8.5** HMRC told us that the ESI tool is a 'rules-based system', based on the tests and principles established in case law and was originally focused on the construction industry. The various factors are graded as high, medium or low, depending on their relative importance (for example, where a genuine right of substitution exists, this will give a 'high' indication of self-employment, as would the exposure to financial risk).

**8.6** According to HMRC, the case law that provides the basis of the ESI tool is based on the case law included in the Employment Status Manual (ESM)<sup>148</sup>. Although, having said that, according to HMRC, the case law incorporated in the tool has not been updated since 2005, which would exclude three of the cases in the ESM, and cases on IR35 would also presumably be excluded.

**8.7** As a result of OTS analysis of the case law from the ESM it would appear to be mathematically balanced, i.e. there are 32 cases of which 27 are non-IR35, 11 are employment rights cases and 11 are tax cases. Within the 11 employment rights cases 5 were found to be employed and 6 self-employed; and of the 11 tax cases 6 were held to be employed and 5 self-employed; of the remainder of the cases 3 were found to be employed and 2 self-employed.<sup>149</sup>

**8.8** In conversation with Oracle, the IT company who code the ESI tool, they told us that they were given an interpretation of the case law to be incorporated into the tool by the HMRC technical team as the basis for the rules. At this stage, the OTS has not been able to ascertain exactly what cases have been used or how they have been interpreted, although it is understood that there are five main factors included and they are: control, substitution, financial risk, business structure and integration. **It is felt that further work is needed in this area, and HMRC should review and update the case law underpinning the ESI, ideally in an open and transparent way.**

**8.9** The general perception amongst commentators is that the ESI is biased in favour of employment. The evidence from the ESM case law used appears to suggest that this is not the case (at least in a mathematical sense), although the OTS cannot conclusively say whether the interpretation of the case law in the ESI is as balanced.

**8.10** In addition, Chart 8.A below does show that the results from the last three years are actually weighted heavily towards self-employment. However, it is not known who has used the tool, or how it has been used (for example, whether the tool had only been used as a 'sense check' by those who were already confident of reaching a 'self-employed' result, or whether users had used the tool multiple times to reach a 'self-employed' result, and had only submitted their final attempt). As a result, whilst these statistics are of some interest, they do not allow a conclusion to be formed on whether the outcome is biased one way or the other.

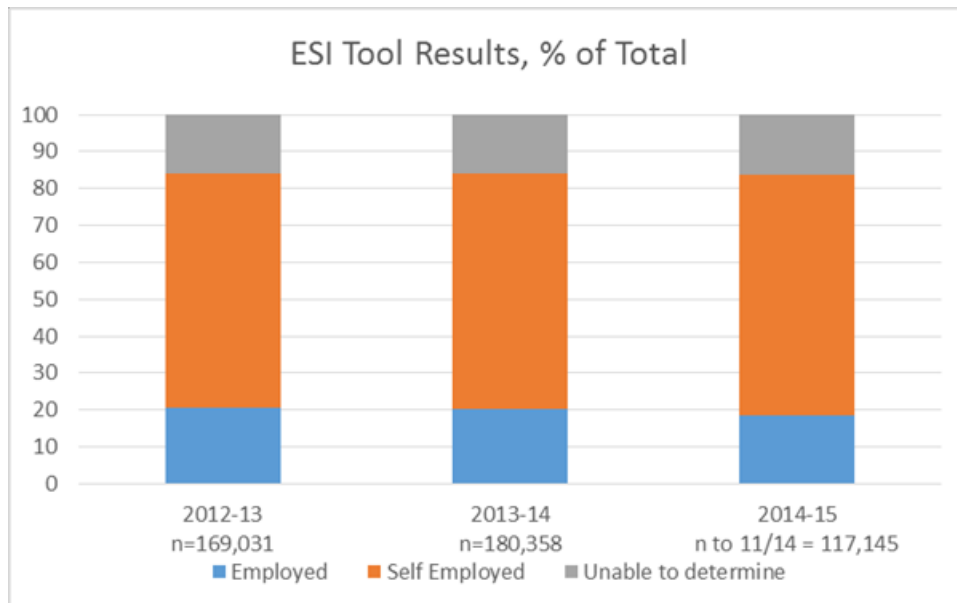
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<sup>148</sup> Annex D Employment Status Manual case law list

<sup>149</sup> The remainder of the results can be seen in Annex D as above.



Chart 8.A:



Source: HMRC

## Mandatory use of the ESI

**8.11** At present the use of the ESI tool is voluntary, although some of the people we spoke to during this review speculated on whether its use should be made mandatory. It was noted that HMRC compliance officers should run their findings through the ESI tool<sup>150</sup>. At present, if HMRC reviews the employment status of individuals engaged by a business, then the business does not need to show that it has used the ESI tool as long as they can provide evidence that status has been considered in some other manner. Such evidence should help to mitigate the penalty position if HMRC were to reclassify self-employed individuals as employees.

**8.12** HMRC noted that, at present, it is possible to complete the ESI questions in relation to two different, but almost identical, engagements, but where a couple of additional questions are answered, the employed or self-employed outcome is different. Examples such as this suggest that the use of the ESI tool could not be made mandatory for customers at this stage, but it could be something to explore (albeit the OTS notes that this is not something that HMRC is currently considering).

**8.13** The OTS noted that when discussing employment status with their clients, accountants tend to go through their own set of questions and investigation rather than simply using the ESI. Some may occasionally check the position against the ESI tool for completeness, but the majority of advisers to whom we spoke said that they would tend not to do so as they were confident in their own knowledge of the issues and analysis of the facts.

## Statutory employment test

**8.14** The OTS asked for HMRC's views on the possibility of a statutory employment test being developed. The possibility of such a test is considered in greater detail in Chapter 9. However, it was noted during our discussions with HMRC and Oracle in relation to the ESI that the 'rules based technology' on which software such as the ESI tool is based, was initially developed with legislation in mind, rather than case law. If a statutory employment test was to be introduced,

<sup>150</sup> COG 907520



therefore, it should not be such a big step to update and amend the ESI tool to reflect the legislation.

## International Comparisons<sup>151</sup>

**8.15** By way of comparison, the Australian Taxation Office (ATO) also have a similar tool<sup>152</sup>, of which there are two different versions<sup>153</sup>:

- [Employee/contractor decision tool](#)
- [Building and construction industry – employee/contractor decision tool](#)

**8.16** After answering some questions about the working arrangement, the tool gives:

- an answer about whether your worker is an employee or contractor for tax and superannuation purposes
- a summary of the responses you have provided
- information about the tax and superannuation obligations you need to meet.

**8.17** Provided the responses accurately reflect the working arrangement, the result provided by the tool can be relied upon.

**8.18** The decision tool is based on Taxation Ruling TR 2005/16 and Superannuation Guarantee Ruling 2005/1 that discuss the various indicators the courts have considered in establishing if a person, engaged by another individual or entity, is an employee within the common law meaning of the term. The Ruling provides guidance as to whether an individual is paid as an employee<sup>154</sup>. Parts of the Ruling are a 'public ruling'<sup>155</sup> and are legally binding on the Commissioner. It may be worth exploring what legal status this Ruling has and whether there is an equivalent method in the UK.

**8.19** Worthy of note is the Australian Tax Office saying that they have made every effort, including consultation with community groups and tax professionals, to make sure this decision tool reflects commercial practices. **It may be worth considering establishing a working group to advise on the workings and case law weightings of the ESI.**

## Use of the ESI tool

**8.20** As noted above, we also looked at the use of the ESI from the point of view of businesses, in order to understand how it is viewed in practice. What was clear from the majority of responses was that if HMRC wish for the ESI to be widely used, and its outputs appreciated and respected, there is a large public relations battle to be won in relation to the tool.

## Views on the ESI

**8.21** The majority of businesses to whom we spoke felt that the ESI was biased in HMRC's favour, in the sense that they perceived that the results almost always indicated that the individual concerned was an employee. However as outlined above, the cases on which the ESI is currently built show a relatively even distribution between cases decided in favour of employment and those decided in favour of self-employment, and the statistics of ESI results

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<sup>151</sup> See Chapter 5 International comparisons and Annex I International case studies

<sup>152</sup> <https://www.ato.gov.au/Business/Employee-or-contractor/How-to-determine-if-workers-are-employees-or-contractors/>

<sup>153</sup> There is also a Superannuation Guarantee decision tool

<sup>154</sup> For the purposes of sections 12-35 of Schedule 1 to the Taxation Administration Act 1953 (TAA 1953) of Australia

<sup>155</sup> For the purposes of Part IVA of the Taxation Administration Act 1953 of Australia

show many 'self-employed' results (although as noted above, we have not yet ascertained how the ESI 'weights' the particular cases in arriving at an outcome).

**8.22** Another common theme, not only from businesses, but also from a number of representative bodies and professional advisers, is that it is felt that the ESI can be easily manipulated to get the result that the user desires.

**8.23** A further comment which was often made during our discussions with businesses and agents was that a number of the ESI questions are open to interpretation, and to use the tool properly requires a reasonable background knowledge of employment status issues and the nuances of the area (it often being cited during our review that on occasions it is necessary to know what the question is trying to ask, rather than what it is actually asking). This issue is further exacerbated by the feeling that the guidance and 'help' functions within the tool do not always clarify any queries the user may have.

**8.24** As outlined in Chapter 6, Managing in practice, different sized businesses have differing capabilities and experience in dealing with complex tax issues. People we spoke to from larger organisations told us that if a member of their specialist in-house tax team was to use the ESI tool, they would almost certainly have an understanding of the area, and therefore have a reasonable chance of being able to use the tool appropriately.

**8.25** However, as previously noted, within organisations of such size, the decision to engage a self-employed individual may be taken by an individual working in a department other than finance or tax, who does not have the same knowledge or awareness of the issues. We heard examples of those individuals using the ESI tool, interpreting the questions differently, and obtaining a different result to that which their finance and tax colleagues would have obtained. Equally, within smaller businesses, the question was whether adequate knowledge and awareness existed at all.

**8.26** For these reasons, many businesses choose not to use the ESI tool at all, and in the case of businesses for whom employment status is a key risk area (such as large construction companies), many have taken the step of preparing their own checklists and control systems, rather than relying on HMRC's version.

**8.27** As an aside, we also heard examples of the workers themselves using the ESI tool. One particular example, outlined by an HMRC staff member, involved a group of individuals providing the same services to the same business being interviewed using the ESI questions. However, the answers to the questions varied amongst this group, depending upon their level of understanding of the questions and how they interpreted them.

**8.28** Therefore what is clear from the feedback we received was that individuals from all backgrounds would like to see improvements to the ESI, so that the questions can be more easily understood, and more reliance placed on the outputs.

**8.29** As a result of the various issues outlined above, it appeared from our discussions that whilst there is a good awareness that the ESI tool exists, it is not widely used. In the cases where the tool was used, we explored the reasons for doing so. A very common response to this question was that businesses were using the tool so that in the event of any future HMRC review, they could demonstrate that they had taken actions to consider employment status issues, which in turn may act as a defence against (or at least mitigate the level of) penalties, especially if HMRC reached a different conclusion and reclassified workers as employees of that business.

**8.30** We heard several examples of businesses using the ESI but HMRC subsequently disputing the outcome. This has led to many businesses concluding that there is no great value in using

the ESI in the first place. Whilst it is acknowledged that working arrangements may change over time (and, therefore, the responses to the ESI questions may be different on day one of an arrangement, compared with at a later stage in the relationship), there is a feeling that businesses ought to be able to rely on the output from the tool. It is widely felt that this should at least limit HMRC's ability to charge penalties (and potentially, PAYE, Class 1 NICs and interest) relating to previous years in instances where the engaging business has properly and reasonably completed the ESI.

**8.31** On several occasions, we were also informed that businesses use the tool because HMRC have requested that they do so, as an improvement to their employment tax control procedures following HMRC employer compliance reviews or, in the case of larger businesses, Senior Accounting Officer reviews.

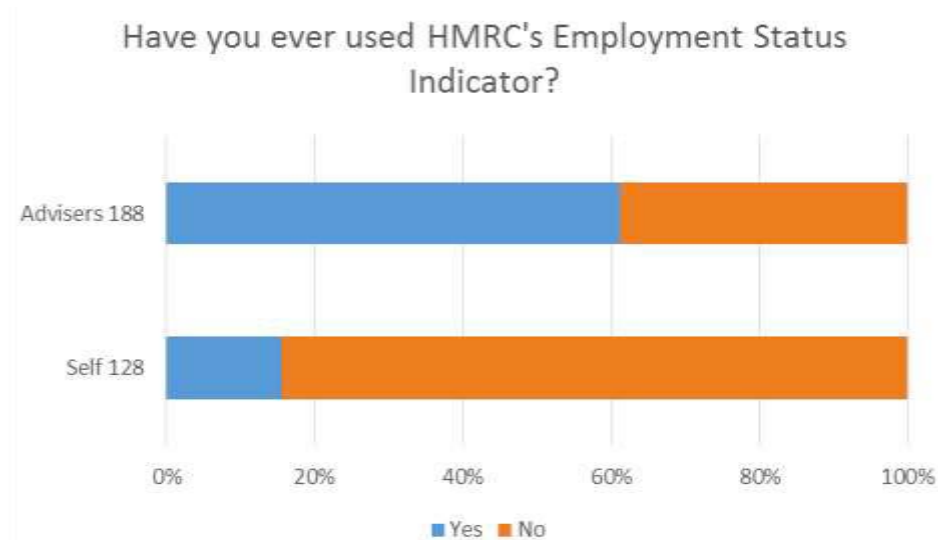
**8.32** We also heard numerous examples of individuals using the ESI tool in order to 'test what HMRC may say', rather than using it to arrive at a conclusive result.

**8.33** These responses seem to add to a general feeling that businesses do not place great value on the ESI tool in its current form, and that the main reasons for using the tool are not the reasons that HMRC would necessarily hope for.

**8.34** We also discussed the ESI with various members of HMRC. The views of the individuals interviewed were that in principle, it can be an extremely useful tool and could be one of the key cornerstones to the whole issue of employment status, and the way in which the issue is managed on all sides. However, it was acknowledged that at present the results of the ESI are not definitive, it could be made more user-friendly, it contains a number of nuanced questions (the subtleties of which are not obvious to the majority of users) and the accompanying guidance was not always helpful. These thoughts echo a number of the comments we heard from businesses.

**8.35** Further evidence of these points can be found in the results of our online survey. The ESI tool is surprisingly little used by individuals in relation to their own affairs, but as can be seen from Chart 8.B below, over 60% of advisers who responded to our survey have used it.

**Chart 8.B:**



Source: OTS survey

**8.36** When asked “what would encourage you to use the ESI?” respondents (combined individuals and advisers) gave the suggestions in Table 8.A:

**Table 8.A: “What would encourage you to use the ESI?”**

	Responses	%
More publicity around the use of the tool	121	46
Clearer questions within the tool	57	22
Clearer Help/explanations of the questions within the tool	56	21
Greater transparency around how it arrives at the results	102	39

*Source: OTS survey*

## Proposed improvements to the ESI

**8.37** It was also clear from our discussions with HMRC that there is a desire for the ESI to be improved and used more widely, and the OTS notes that HMRC are working to achieve an upgrade in 2015, incorporating enhancements and improvements to deliver a more user-friendly and reliable tool. With this in mind, it is therefore useful to note a number of the comments we heard from businesses around what improvements they would like to see to the ESI, and what might encourage them to use it more frequently:

**8.38** The ESI is considered by many businesses and their advisers to be too ‘black and white’, in the sense that it does not reflect the intricacies of modern working relationships and arrangements. **Businesses may be more inclined to use the ESI if the questions were more readily applicable to the situations that they deal with on a day-to-day basis.**

**8.39** Taking this a step further, many businesses would be more likely to use the tool if it **contained more industry-specific questions.** This may mean that the user of the ESI would be able to indicate the type of worker for which they are seeking to obtain an employment status opinion, which may in turn generate some questions that are specific to their situation, and filter out some questions which aren’t. It is worth noting that this comment was also echoed in our discussions with HMRC.

**8.40** It should be acknowledged that there are limitations to broadening the scope of the ESI – clearly it is not practical to develop an ESI tool to cover every trade and profession. However, the development of the ESI into a tool which is not quite as general as the current version appears to be a concept that would be welcomed by all parties. The Australian example of a two version system is relevant here.

**8.41** Developing that theme further, there is a risk that the ESI does not work as well as it should because it tries to cover all situations and in particular tries to help businesses and individuals, those who have no knowledge of the area and those who have a good knowledge. **It may be that the ESI should be more clearly positioned as a tool to assist the non-expert, ordinary individual and small business.**

**8.42** In addition to a number of the questions being reworded in order to address certain ambiguities and nuances that are currently present, users of the ESI would like to see the supporting guidance and “help” functions improved, including with the use of “real world” examples in order to add clarity to the questions. Such improvements should help to make this a tool that does not require the user to have specialist tax knowledge.

**8.43** Many businesses and representative bodies also indicated that if the ESI tool is properly and reasonably completed (a concept that would clearly need to be defined), then the results

**should be definitive.** As noted, the ESI becomes devalued if a clear result from what is seen as HMRC's system is then challenged by HMRC at a later date. At the same time, we fully appreciate that HMRC must have the power to challenge situations where the ESI has been completed wrongly or of course where working arrangements do not reflect the answers given to the ESI questions. Proper use of the ESI should deliver certainty, at least up to the point where the 'ruling' is challenged by HMRC.

**8.44 In order to be more widely used and of greater application, the tool should also be made more user-friendly and the software improved.** Many individuals who have tried to use the ESI gave examples of the software "freezing" or closing down during the session. The OTS understands that HMRC is aware of this and is investigating the cause.

**8.45 It was also considered by a number of individuals that if the ESI is to have a more formal position (for example, if it was to be enhanced, and the use of the tool possibly even made mandatory), then it would need some form of independent oversight before businesses and professional advisers would have confidence in it.**

**8.46** This links to a point made earlier around the 'public relations battle' which would need to be won before the ESI becomes more widely (and potentially universally) used – at present, whatever improvements are made to the ESI, it remains an HMRC tool, and without independent oversight, many businesses will always retain some scepticism that the tool is simply programmed to produce the results that HMRC wish to see. At the same time, the OTS can see that HMRC would be reluctant to surrender control of the tool to a separate body. It may be that consultation about changes to the tool and more openness and transparency about its way of working will solve these concerns. **We think that the idea of a joint working party to look at the case law underpinning the ESI would go a long way to answer these concerns.**

## 9 Statutory employment test

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**9.1** It is probably fair to say that the idea of a statutory employment test to determine employment status was not in our initial thinking when we set up the OTS's employment status project. There is, after all, no vestige of a test in the tax statutes at present.

**9.2** However, the concept was something that came up in many initial meetings and so it became something that we explored as a matter of course, often at length, during our evidence gathering work. The statutory employment test idea aroused a lot of interest and attracted a lot of support – but also a lot of reservations.

### What do we mean by a statutory test?

**9.3** This should be obvious: the rules to determine employment status would be in statute. As far as possible that means primary legislation, though inevitably some aspects would no doubt need to be amplified (or illustrated) in guidance. The OTS would not recommend such an important issue be determined by secondary legislation.

**9.4** In most of our meetings and submissions, the example of the statutory residence test<sup>156</sup> was clearly in peoples' minds. Views on that did colour some comments. In many cases the statutory residence test was seen as a source of complexity: the length of the legislation was often criticised. At the same time, many saw the statutory residence test as a significant step forward: '...at least we know what the rules are...' was a regular comment. Overall, the views of those we took evidence from were positive on the statutory residence test and its impact. That encouraged many to approach the idea of a statutory employment test positively, but at the same time the experience of the statutory residence test should be seen as something to draw lessons from if a statutory employment test is pursued.<sup>157</sup>

**9.5** The starting point would be that the test would apply to all taxes: income tax, NICs and VAT in particular.

### What would a statutory employment test contain?

**9.6** We think there are two broad approaches that could be taken to a statutory test:

- (i) Detailed: a comprehensive set of rules, dealing with all (or at least as many as possible) situations and reflecting all aspects of current law that are still relevant and appropriate (on the basis that some are outdated)
- (ii) Simple (or pragmatic): a short set of quantitative tests that were easy to address and deal with

**9.7** A detailed test would reflect current case law and would synthesise the principles and rules that have emerged from the body of cases on the area. This would clearly be a complex task, given the range of cases and (at times) the varying principles that emerge (see Chapter 2). But in principle it should be possible: after all, any new judgement goes through this process.

**9.8** A simple/pragmatic test would take a rather different approach. It would set down a short series of tests (as few as two, possibly as many as five, though no doubt some would suggest

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<sup>156</sup> Section 218 et seq Finance Act 2013

<sup>157</sup> In some meetings it was acknowledged that the statutory residence test had grown more and more complex as it tried to deal with more and more situations. That could be seen as responding positively to consultation responses; also as giving in to lobbying!

there could be more). Some countries (Australia and Italy are key examples<sup>158</sup>) have gone down this route and focus on:

- The proportion of working time with an organisation
- The proportion of income derived from an organisation

**9.9** The test is usually that if more than (say) 80% of income or time relates to one organisation, the individual is an employee.<sup>159</sup>

**9.10** Another route would be to develop a de minimis (or 'minimax') approach<sup>160</sup>:

- Working for an organisation for more than X months continually would mean you are automatically an employee
- Working for less than Y days/weeks for an organisation (possibly over a year) means you cannot be an employee<sup>161</sup>.

**9.11** As illustrations, a number of meetings suggested that 6 months would be a break point, i.e. more than six months' work would mean employment.<sup>162</sup> The other end of the spectrum was usually suggested as in the 2-4 weeks range, with most agreeing that under 2 weeks should not bring employment.<sup>163</sup>

**9.12** In framing a statutory employment test one decision to be taken would be whether situations where an individual's employment status is clear-cut would be excluded from the test. If the test were on a 'decision tree' format the idea would be to start with questions that in effect identified the clearly employed and clearly self-employed and only passed those whose status was not 100% clear into the full test.

**9.13** However, assuming that the aim would be to include in statute tests that identified everyone's employment status, the tests would have to include rules to categorise even those who were clearly employed or self-employed. In practice, those whose status was clear (or their 'employers') would not use the statute but it would be wrong not to cater for them in the tests. In many ways, that would follow the format of the statutory residence test where initial tests identify the clearly resident or clearly non-resident, leaving the bulk of the statute to deal with those whose status is not immediately clear.

## What is the attraction?

**9.14** The obvious attraction of a statutory employment test is that there are clear rules that all have to abide by. It has the potential to deliver the certainty that so many of our commentators (particularly businesses) see as the biggest issue. It similarly has the potential to cut down disputes.

**9.15** There would also be a timing advantage, in that a properly-designed rule would answer an individual's (or hirer's) question now. It would provide an answer that would operate through

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<sup>158</sup> See Chapter 5

<sup>159</sup> Italy also has regard to whether the putative employee is provided with a desk.

<sup>160</sup> This sort of test undoubtedly appeals to industries that frequently hire people for a day or two – road haulage and farming have been mentioned.

<sup>161</sup> It was also suggested that there could be a test linked to amount of income – i.e. anyone paid less than £Z (possibly over a year) by a hirer could not be an employee. This could also be framed the other way round – anyone paid more than £Z would be an employee.

<sup>162</sup> Though in a couple of meetings it was argued that six months would be the point at which employment status would be considered, i.e. that up to that point self-employment would be automatic.

<sup>163</sup> Most of these discussions were on the basis that the individual was working full-time for the period in question. It was readily acknowledged that working part-time would need to be considered in developing the concept. That was why some people preferred the approach of 'day counting', especially to develop a de minimis exclusions, e.g. fewer than X days over Y months.



the assignment. There would be no risk of reopening the issue (subject as always to questions of false answers to the tests).

## How would it operate?

**9.16** The fact that a statutory employment test would be in statute makes it accessible in principle. Those that need it could refer to it and find the answer to their situation. No doubt, as with the statutory residence test, the vast majority of situations would be clear cut (and indeed would not even be tested against the statutory employment test). Where there was doubt, some research would find the answer. As with any statute, there would still potentially be boundary disputes, which would have to be resolved by the Tribunal, who would at least have a set of rules to examine.

**9.17** One probable difference between the two approaches outlined above is the nature of the tests that they would incorporate:

- A detailed statutory employment test would probably involve a number of judgmental tests, potentially with qualitative answers in many cases
- A simple, pragmatic test would be based on tests that would be quantitative and so easier to answer

**9.18** The same set of rules would be used by individuals, businesses and HMRC to determine an individual's employment status.

**9.19** It has been suggested that any statutory employment test would contain a tie break or a default option.<sup>164</sup> The aim would be to give certainty and preclude many disputes. The risk with such an approach is that it becomes arbitrary and would be seen as unfair; the counter argument is that it would get to a result and would mean that the test did produce a definite answer. There would still be the possibility of the taxpayer (or indeed HMRC) appealing against a result with appropriate grounds.

## Wider issues

**9.20** So far the discussion has proceeded on the basis that it is applied directly to an individual's status. However, many individuals work through agencies, umbrellas or personal service companies. Could the statutory employment test apply to them on a 'look through' basis? There is some attraction and logic in this approach, particularly for the personal service company situation to determine the applicability of IR35. But would the test be operated by the individual or the agency/umbrella? In both cases, questions would need to be addressed over when the test would be applied in what might be seen as a continuous situation.

**9.21** Where a statutory test has the potential to become very powerful is if it applies to all areas – i.e. it is not just a statutory tax test but also covers at least:

- Employment rights
- National Minimum Wage
- Pensions auto-enrolment
- Tax credits/universal credit

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<sup>164</sup> The US 'ABC test' discussed in Chapter 5 effectively takes this approach: the individual will be treated as employed unless the three tests are all satisfied.



**9.22** The possibility of a universal test for employment status was one of the most attractive features seen by commentators during our work. Indeed, to many people this would be a requirement: their support for what might be a complicated rule was predicated on the basis that it would apply to employment rights. It would therefore answer a key requirement from business: that they were not exposed to claims for employment rights from an individual contractor who had been agreed to be self-employed for tax purposes.

## Issues, concerns and possible answers

**9.23** As already alluded to, the support for the concept of a statutory employment test was tempered and in some cases even overshadowed by the problems people envisaged with such an idea in practice. The main issues were seen as:

### Complexity

**9.24** A statutory employment test would be necessarily complex if it was trying to answer all questions and encompass all current rules and individuals' situations. The counter to this was that there is an alternative, simple route to take in designing a test.

### Inflexibility

**9.25** Case law adapts easily to changing circumstances and differing fact patterns. A statutory test would be set in stone and would be cumbersome to alter (in that it would need a change to the statute, possibly preceded by consultation and statements about change). Working patterns and practices change increasingly rapidly: could a statutory rule keep up?<sup>165</sup>

**9.26** Against that, there have to be questions as to how much circumstances do really change – is it more that successive judges see things differently and put their own stamp on things? Or that people wish to try different arguments in slightly differing circumstances? And would it not actually help if there were settled rules for a period that were not constantly changing or evolving? One of the biggest concerns we have heard in meetings is that the current employment status system can cause unfairness and uncertainty – that a group of individuals doing similar jobs can find themselves with different statuses. Similarly, a business can be undercut by a competitor who manages to classify individuals as self-employed even though all seem to be doing similar work. A statutory test may be inflexible – or have rough edges (see also below) but it has the potential to deliver certainty and a level playing field.

### Annual or job-by job?

**9.27** The statutory residence test is an annual test, assessed (in the main) for a tax year; this works because it is based on the actual days in the year. A statutory employment test would ideally set a status for an individual that would hold for the future of that assignment at least – but a test taken today on one valid set of circumstances would possibly be invalid tomorrow if those circumstances changed.

**9.28** For example, what if an individual decided to give up her other work (a major factor in the decision that she was self-employed) to concentrate on one key assignment? That might make her employed...but would she have to redo the tests whenever her circumstances changed (how to define that) or would the test hold for a set period?

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<sup>165</sup> Many people cite the recent growth in zero hours contracts as an example.

## Individual or job-by-job?

**9.29** To develop the last point, would the test apply to an individual's situation or simply codify the status of one role? Ideally it would cover the individual and give him a 'certificate' – but circumstances change. If it were to apply job-by-job, can that be assessed without reference to the wider situation?

**9.30** There are instances of individuals having more than one work source where neither engaging organisation would accept the individual with the employment status the other wants.<sup>166</sup> It would be difficult to label an individual to allow them to operate freely in such circumstances. These are valid concerns and if a statutory employment test is developed, decisions would be needed on how and when it is to be applied.

## Individual vs. company

**9.31** Would this be a rule that applied just to the individual? If so, incorporating one's activities and working through a company would be a simple way to sidestep the test. The response has to be that the test could apply on a 'look through' basis to those working through a company (personal service company or other arrangement), though that immediately opens up wider issues of IR35-type enforceability.

**9.32** It would be logical to apply the same rules to the individual as to the IR35 situation. More problematic or questionable is whether the statutory employment test would apply to the person working through an agency or umbrella company. This also raises questions on whose job it would be to apply the test. The onus should be on the individual but no doubt agencies in particular would have concerns over whether they would be expected to help individuals or indeed apply it. The practical answer may be to deem those working through an agency as employed but subject to existing agency rules rather than full employer payroll procedures.

## Rough edges

**9.33** This is potentially a significant issue for a 'simple test' approach. If there was a rule that said 'X% of time', those who ended up just either side of the rule would perhaps feel hard done to. More seriously perhaps, someone who was treated by the rule as being an employee but could show a full panoply of other self-employed features (around control, pay by results, substitution etc.) would see it as arriving at the wrong answer.

**9.34** The counter to all these objections is that any rule will have some edges or boundary issues. The person with a lengthy period of working for one organisation from a normally self-employed situation is vulnerable now to being classed as an employee for that assignment. The advantage with the putative new rule is that the individual and their hirer would know where the boundary is and that they would be 'caught' – and know it at the time rather than months or even years later after an HMRC challenge.

## Rough edges (2) – de minimis problems

**9.35** As noted, a possible approach to a statutory employment test would be to include some de minimis exclusions, or to take a minimax approach. Probably the biggest concern with a de minimis basis would be that of potential tax loss: many short term or casual workers being classed as 'not employees' and therefore potentially self-employed. The solution to that issue might be to combine the rule with the withholding tax idea that is discussed in Chapter 11: that anyone who is excluded from consideration as an employee by reason of their engagement

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<sup>166</sup> An example we were given was that of an employee of a large accounting firm who undertakes exam marking work for a professional body.

falling below X days is subject to a set withholding tax percentage on their pay, duly reported to HMRC by the payer.

## **Gaming the rules**

**9.36** This is linked to the previous point. If it is known that an 80% or a 6-month rule applies, then the situation could be ‘managed’ to give a suitable break.<sup>167</sup> That was a concern in the design of the statutory residence test – but the counter with both tests is that at least the rules are clear and that at present there is a good deal of ‘gaming’ attempted in any event around the rules.

## **People will be pushed over the boundary in one direction or another**

**9.37** This is an aspect of gaming, but the point is that it is the hirer who does this manipulation rather than the individual (or both parties). It is certainly likely to be a particular concern if a ‘de minimis’ route is set up as that would give a route for less scrupulous employers to make sure individuals did not become employees and so entitled to rights.

**9.38** Then again, would this be much different in practice to what happens already – and might it actually ensure that such vulnerable employees at least have a clearer idea of their position and know what the implications are?

## **This would not solve the problem – it would just move the arguments to a different place**

**9.39** The point being that rather than arguments about what the body of case law and evolving practice means, it would be arguments about the words of the statute. Nobody would expect a statutory rule to solve all problems and mean there were never any arguments but the aim would be to cut down significantly on the scope for disputes. There would still be an appeal route available.

**9.40** As with any tax statute, there would be possibilities of an appeal to the courts about the result on the basis of the wording of the law. But it would be for discussion whether there should be an inbuilt appeal possible if the test gave a manifestly absurd result. This is an issue that would need to be explored during consultation: the starting point would be that the test would be designed so as not to give such results – but if examples are cited which cannot be easily dealt with in the law’s drafting, a limited appeal route may be the solution.

## **A statutory rule would not be accessible to the ordinary worker**

**9.41** A typical worker would never be able to access those rules in practice: they would never look at the actual law. This is probably true – but if there is a statutory rule, it must be possible to reduce it to explanatory notes/guidance and in particular to code it into HMRC’s online Employment Status Indicator tool. Plus the hirer will be expected to apply the rules – and one would envisage interested parties (unions, support groups and others) developing guidance in everyday language. Also, surely the position would be an improvement on the current situation where the guidance available to the average worker is very convoluted.

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<sup>167</sup> We have referred elsewhere in the report to the experience of someone who worked at an organisation which adhered to ‘the 9 month rule’ – i.e. that someone who had worked for that period (not necessarily full-time) had to have a 3 month break before they could be used again. She had been caught in this rule, having had a modest amount of work during a 9 month period and then being asked to do something again – which led her to a ‘penalty’ of not being used again for a year. She was under the impression that this was a statutory rule.

## **It would encourage individuals to try and solve complex situations themselves rather than take necessary advice**

**9.42** Frankly, this would be the aim. If it cuts down on the amount of advice needed, that is surely a good result as it proves that simplification has been achieved. That is not to say that some advice or assistance will not be needed: there will always be complex and unusual situations that would benefit from expert input; equally some vulnerable individuals will always need support.

## **An alternative route to tying things up**

**9.43** One of the aims of a full statutory residence test would be to get to a situation where the same rules applied to tax and employment rights (and other areas). The problems this creates are typically:

- The individual who believes they are employed (with appropriate rights) but finds later that he is not on the payroll but self employed
- The business that hires a contractor and pays her accordingly (and she pays tax as self-employed) but is later sued for redundancy money (or other employee entitlements)

**9.44** One route to alleviate the problem – though not by any means a complete solution – is to introduce a rule that says anyone that is taxed as self-employed must sign to say that they accept that position and accordingly undertake not to claim against the employer for employment rights. Such a system is in use in Germany (discussed further in Chapter 5).

**9.45** One immediate objection from the individual's point of view is that it would be easy to pressure people into signing such an undertaking on the basis that 'you sign or you don't get the work'. That is a genuine concern – but it already exists and at least having such a rule brings the issue to the surface (and might allow interested parties such as trade unions to police it to some extent).

**9.46** It is also a rule that would have to apply to the benefit of the employee – so the individual prepared to sign it would have to be guaranteed that she would be taxable as self-employed. That would no doubt concern HMRC who would see it as vulnerable to manipulation and potentially lead to a loss of NICs. There would have to be inbuilt protections (e.g. it could not be used to override a clear employment relationship – though such a rule might immediately itself be a source of disputes). These impacts would need to be assessed in considering whether to pursue this sort of route.

**9.47** There would be wider concerns from HM Treasury and HMRC on the potential impact on NICs revenues, of course. The German system does have a stronger link between paying contributions and gaining benefits (and not paying, and not gaining), meaning there is likely to be a better balance.

**9.48** Despite the potential objections this route does seem to have some merit and the OTS believes it is worth exploring further. It would clearly be relevant to learn more of the German experience. However, the differing rates of NICs contributions in the UK may make it difficult to pursue – though that emphasises again that the biggest issue in the UK is the differences between the employed and self-employed NICs rates, especially employers' NICs.

## Conclusions

**9.49** The idea of a statutory employment test cannot be dismissed. It is an attractive goal in that it removes uncertainty. A statutory employment test that could apply ‘across the board’ – especially to employment rights – is very attractive. It would be transparent: the rules would be known and understood.

**9.50** Whether such a test could be developed is another matter. It is a moot point how significant the ‘lack of flexibility/adaptability’ objection really is: if the rule changes only occasionally, that is no bad thing in many ways. The main practical problem would be developing something that would operate in tandem with employment rights. It seems worth opening up a debate to test whether that is possible.

**9.51** What about the ‘simple’ route? The sort of test used by Australia or Italy would be possible. The key objection is that in aiming for simplicity, it would be rough and ready. It would probably only be useable for tax, and not employment rights (though perhaps tax-related issues such as National Minimum Wage and tax credits might use it). The key issue is probably whether Ministers are attracted to the idea. From a pure simplification point of view, this route has a good deal to recommend it though we readily acknowledge the potential downsides: at the same time we have shown that the arguments on all sides are balanced or at least seem capable of resolution.

**9.52** The German system described above, although not a proper statutory employment test, also has attractions as a means of giving certainty to both sides.

**9.53** Overall, the OTS believes that the statutory employment test is an idea that needs to be taken further. The sequence should be:

- (i) Discussing whether (or how) other parts of government would be prepared to apply such a rule in the same way.
- (ii) Developing a discussion paper based on the points in this chapter, incorporating the results of the ‘whole government’ approach.
- (iii) Testing the ideas in the discussion paper in some workshops with relevant stakeholders.
- (iv) Working up a proposal based on the most promising route (which would decide whether the detailed or simple route was the preferred option, for example) for consideration by Ministers.
- (v) Full consultation before a decision to proceed.

Part 3:

# Indirect routes to take the heat out of the problem

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# Tax and national insurance differences

## 10

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**10.1** The differences between income tax and NICs are well known as a major driver for the problems around employment status. However, changing – possibly even eliminating – these differences would not solve a single employment status dispute. What this would do is to considerably reduce the amounts of money at stake and so make arguments much less likely. Consequently the OTS has to look at what changes could be made to achieve this indirect solution to the employment status problem.

**10.2** In this chapter we will look at:

- some of the background to and underlying principles of NICs
- income tax: differences between employed and self-employed
- issues that arise because of differences between income tax and NICs
- conclusions – how to improve matters
  - (i) harmonising NICs for employed and self-employed
  - (ii) bringing income tax and NICs together
  - (iii) tackling employers' NICs

**10.3** We develop some recommendations, though inevitably these are concerned with significant structural issues.

### Background: the NICs story<sup>168</sup>

**10.4** Historically, the self-employed were included in the 'welfare state' for the first time in 1942, see the Beveridge Report<sup>169</sup>. The National Insurance Act 1946 introduced three classes of contributor, class 1, 2 and 3, to make up the funds required:

- for paying such benefits as are payable out of the National Insurance Fund, and not out of other public money
- for the making of payments towards the cost of the National Health Service

**10.5** Class 1 is earnings related, payable by employed earners (primary contributions) and employers (secondary contributions)<sup>170</sup>. Class 2 is a flat rate charge, payable by self-employed earners and Class 3 payable voluntarily with a view to providing or enhancing entitlement to benefits. The different classes confer different levels of benefits.

**10.6** In 1975, class 2 had increased to 90% of the combined cost of the flat-rate class 1 contracted out contribution, but it had fallen to 40% of the combined total of flat-rate and

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<sup>168</sup> We are only giving a short summary of NICs here; for fuller explanations the Institute for Fiscal Studies have a very useful paper at [www.ifs.org.uk/bns/bn09.pdf](http://www.ifs.org.uk/bns/bn09.pdf): the NICs section starts at page 14. The HMRC site also has extensive coverage at [www.gov.uk/personal-tax/national-insurance](http://www.gov.uk/personal-tax/national-insurance).

<sup>169</sup> [http://www.nationalarchives.gov.uk/pathways/citizenship/brave\\_new\\_world/welfare.htm](http://www.nationalarchives.gov.uk/pathways/citizenship/brave_new_world/welfare.htm)

<sup>170</sup> It is worth noting that employer's contributions have been a feature of NICs from their introduction by Lloyd George in 1911. The principle seems to be simply that the employer and employee should jointly fund the benefits to the employee.



graduated contributions for a contracted out employee on average earnings. However, benefit entitlement is restricted compared to class 1 (see Annex H).

**10.7** Raising the flat-rate contribution of class 2 to a sufficient level would have caused hardship on those of the self-employed whose income was low. So, in the Social Security Act 1973, an additional contribution of 5% of relevant earnings from the self-employed with earnings above a certain level (profit based) was introduced. The contribution was collected through Schedule D tax assessments and paid in bulk to the National Insurance Fund and called class 4. In 1975, class 4 was raised to 8%. The class 2 rate was also raised by 22.9%.

**10.8** In 1977, The Federation of Small Business (FSB) undertook litigation against the Government on the basis that the class 4 contributions had no mathematical or actuarial base, did not provide the right to benefits (since class 2 does that) and therefore should be repealed. Although the FSB lost their case, in 1978 the rate was reduced to 5%, in line with reductions in other rates. However, it has subsequently increased to 9% (up to the upper profits limit, equivalent to the upper earnings limit, 2% thereafter).

## NICs rates on employment

**10.9** Under class 1, access to contributory benefits (for 2014/15) starts at £111 per week, however contributions are payable once earnings reach the primary and secondary thresholds of £153, at the rate of 12% and 13.8% respectively. Primary contributions drop to 2% above the upper earnings limit of £805, but secondary contributions have no upper limit.

**10.10** Class 1A contributions are payable by employers on taxable benefits in kind at the rate of 13.8%. Class 1B contributions are payable at the same rate when an employer enters into a PAYE Settlement Agreement (PSA) with HMRC, payable on all items that would normally be chargeable under Class 1 or Class 1A, and in addition, on the income tax payable under the PSA.

## NICs rates on self-employment

**10.11** Class 2 is payable at the weekly rate of £2.75 (2014/15), subject to an exception for small earnings below £5,885 per annum. Class 4 has a lower profits limit (2014/15) of £7,956 (equivalent to £153 per week), with 9% contribution above this amount, until the upper profits limit of £41,865 (equivalent to £805 per week) is reached, with 2% payable above this point. Following an earlier OTS proposal, the collection of Class 2 and Class 4 NIC is to be through the Self-Assessment system from April 2015.

## Voluntary NIC rates

**10.12** Class 3 is a voluntary contribution payable at the rate of £13.90 per week, to satisfy contributory conditions for entitlement to certain benefits<sup>171</sup>.

**10.13** Class 3A is a new voluntary contribution to provide a top-up to the state pension where an individual may have gaps in their contribution record. It will be available from October 2015 for 18 months, for people with an entitlement to a state pension and who reach state pension age by 6 April 2016. The maximum amount that these contributions can provide will be £25 per week.

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<sup>171</sup> Table 3 Annex H

## Income tax: employed vs self-employed

**10.14** Income tax rates and the personal allowance are the same across employment and self-employment. There are, however, two crucial areas of income tax differences: payments arrangements and expenses.

### Paying tax

**10.15** Employment income is subject to the Pay As You Earn (PAYE) system, while self-employment income is payable under self-assessment with the balancing payment of tax (and class 4 NICs) due on 31 January following the end of the tax year, with payments on account having been made the previous 31 January and 31 July.

**10.16** The possibility of a wider requirement to deduct tax at source from payments to the self-employed was raised in a number of our initial meetings and it became a topic we raised to test opinions. There are two immediate points in favour of doing this:

- the deduction means that payees will be paying some tax and are more likely to enter properly into the tax system, i.e. it would help combat evasion
- the deduction would act as a payment on account for the individual's tax liability, potentially allowing the existing payment on accounts system to be dispensed with and leaving only modest amounts to be paid at 31 January

**10.17** As one person put it: "a Construction Industry Scheme style system for deducting tax from self-employed individuals and/or reporting the payments to HMRC would make sure everyone is "in the system" – the deduction could be in excess of what is actually due, which may incentivise individuals to file their returns more quickly".

**10.18** We think this is a route worth pursuing and develop the idea fully in Chapter 11.

### Expenses

**10.19** The conditions for deducting expenses in arriving at assessable income are different, with a more restrictive regime applying for employment income. This appears to originate from the Finance Act 1922, when non-public employments were transferred from Schedule D Case II to Schedule E, which had a more restrictive expenses code.

**10.20** The area of expenses is strictly outside the terms of reference for this review, so we have not investigated the issue to any significant extent. However, we have to report that we were regularly told that aligning the expense systems would be logical and might alleviate the practice of artificial provisions of labour through personal service companies and umbrella companies.

**10.21** On the surface, it is difficult to see how the rules could be harmonised: the self-employed have a wide range of valid costs of running their business; employees incur few costs directly relating to their work. There would be great concern that any harmonisation would alter the treatment of travel costs for example – allowing commuting costs for employees or barring travel to client costs for the self-employed.

**10.22** Harmonising would potentially mean dropping the 'necessary' requirement from the employees' expenses rules. Both forms of work would then rely on the 'wholly and exclusively' rule. HMRC would no doubt be concerned that this would open floodgates – but it is not entirely clear that it would, especially if the rule were qualified in terms of 'once at work', to exclude commuting costs. At the same time, the way that the wholly and exclusively rule works can be capricious and both employees and the self-employed have found this a problem in

recent cases<sup>172</sup>. Other OTS reports (on Small Business and on Employee Benefits and Expenses) have noted this, with training costs being a regular issue. We suggested that there was a need to look at policy for the allowability of training costs in particular.

**10.23** We have not investigated this issue properly because of the restriction in our terms of reference. We are aware of the current HM Treasury review of travel expenses, following on from our own work, and hope this will be pursued properly. However, the HM Treasury review focuses on employee's expenses and it seems to us that there is a need to expand the review to look at the position of the self-employed as well. What we have heard leads us to conclude that there is a need for a proper review of the rules around expenses, to ensure that these are appropriate for current working practices.

## Issues in income tax and NICs

### Starting point (1)

**10.24** The annual personal allowance for income tax is £10,000 for 2014/15, equivalent to a little over £192 per week. While the primary and secondary NICs thresholds were aligned with the income tax personal allowance in 2001, this alignment only lasted until 2007/08<sup>173</sup>. There have been a number of policy-driven increases in the personal allowance in recent years, resulting in a considerable difference in starting point.

**10.25** In 2011 the OTS calculated that increasing the primary NICs threshold to align with the personal income tax allowance would directly reduce tax receipts in excess of £1 billion<sup>174</sup>. With recent increases in the personal allowance, the current figure would clearly be much greater and would naturally need to be considered carefully. However, useful administration savings for both taxpayers and HMRC would result from integration.<sup>175</sup>

### Starting point (2)

**10.26** It should be noted that at the lower end, say income of £6,000, an employee on equivalent weekly wage will pay no class 1 national insurance (although will be entitled to benefits), whilst the self-employed will pay class 2 national insurance for a reduced benefit entitlement. We have heard that there should be a nil rate band with benefit entitlement for the self-employed as well as the employed, and this could clearly be achieved by harmonising the NICs rates across the different contributors.

## Rates of NICs

**10.27** The employed and the self-employed pay different amounts of NICs, at least until the threshold for the 2% rate is reached. Although the difference between Class 1 (primary) and Class 2 + 4 is not great, it does present an obvious differential and so an apparent incentive to self-employment. However, the benefits available to the self-employed are lower than to the employed, though the differences are reducing. As we noted in the section on the

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<sup>172</sup> A recent example concerning issues around both employed and self-employed expenses rules is *Samadian v R&C Commissioners* [2014] UKYT 0013 (TCC).

<sup>173</sup> Although 2008/09 initially maintained the alignment; the link was broken when the personal allowance was increased by £600 in the wake of the abolition of the 10% starting rate of income tax.

<sup>174</sup> OTS Small Business review: Interim Report

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/199183/05\\_ots\\_small\\_business\\_interim\\_report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf)

<sup>175</sup> It is difficult to estimate the administrative savings from individual changes en route to integration. In a 2007 paper by the Tax Law Review Committee of the Institute of Fiscal Studies - Integrating income tax and national insurance: an interim report - the authors comments that "The best estimate of potential savings for employers under an integrated system would appear to be the approximately £179 million annual incremental cost of NICs identified by the KPMG study. This total is perhaps surprisingly low. It is important to recognise, however, that the Standard Cost Model used in the KPMG study captures only a narrow measure of compliance costs, excluding, for example, costs associated with working out what must be complied with, dealing with changes, and tax planning, which could be significant." See <http://www.ifs.org.uk/wps/wp2107.pdf>

categorisation regulations (Chapter 3), the proposed introduction of a flat rate state pension from April 2016 further reduces the link to payment of NICs.

## Secondary/employers' NICs

**10.28** The preceding points in this section, although significant, are minor compared to the “big one”: employers' NICs. The fact that there is a 13.8% charge for employers on all pay above the secondary earnings threshold is a huge factor in disputes over employment status. We have constantly been told that one of the main concerns for businesses is risk management – managing the risk of exposure to (1) employment rights claims and (2) further tax/NICs costs (see Chapter 6 for further discussion). We probed the latter a good deal and the message we heard was not that businesses are trying to avoid employers' NICs: they simply want to know for certain whether they have to pay them. If they do, they can price them into their cost of doing business.

**10.29** For individuals, there may well be more motivation to avoid the employers' NICs. That may seem an anomalous statement – in that the employers' NICs are not paid by the employee. However, the point often made to us by those speaking for workers (and some employers) is that if no employer NICs are due, the worker is cheaper to hire and so more likely to be asked to do the job. The corollary, and an important one, is that employees may be pressurised into working as self-employed to help less scrupulous employers avoid employers' NICs. This is a particular concern for those dealing with the low paid.

**10.30** Paying the employers' NICs does not result in any benefit entitlement for either party, of course.

## Dividend vs salary

**10.31** The extraction value of profits after taxes is higher by drawing a dividend than by taking a salary. The reason for the difference is the absence of NICs, although this is partly offset by corporation tax relief for salary payments and employers' NICs. This is demonstrated in Tables 1 and 2 in Annex H, looking at a basic rate taxpayer (£400 per week) and a higher rate payer (£1,000 per week) respectively.

**10.32** The dividends route produces a higher extraction of after tax profits than a bonus at both levels, although the £2,000 employment allowance against employers' secondary class 1 NICs can affect this as set out in the table footnotes. Comparing employment with self-employment, self-employment has a higher income extraction after tax, due to the lower rates of NICs discussed above, although this is more marginal in Table 1. The increase in engager costs for the employment route is also shown.

## Benefits in kind

**10.33** Income tax and NICs treatment on various benefits in kind are very different. A list of the differences was set out in the OTS Review of Employee Benefits and Expenses Interim Report<sup>176</sup>.

## Conclusions

**10.34** Reducing the differential between the different tax and NICs rates and treatments for different income streams would reduce the incentives to distort behaviour, and simplify the system for taxpayers, advisers and HMRC. Such a move towards a single tax and national

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<sup>176</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/227088/ots\\_employee\\_benefits\\_interim\\_report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/227088/ots_employee_benefits_interim_report.pdf). Annex E

insurance system was considered to represent a considerable simplification of payroll administration for employers, as well as reducing HMRC administration.

**10.35** This is clearly not a new issue. In 2007, HM Treasury publically commented on this in their paper 'Income Tax and National Insurance: An evidence based assessment', and the Mirrlees Review<sup>177</sup> commissioned by the Institute for Fiscal Studies came out in favour of integrating the two systems into a single tax. These issues have already been commented on by the OTS in our Small Business Report,<sup>178</sup> which noted that maintaining two separate systems led to a number of anomalies that may provide incentives to distort behaviour.

**10.36** Following the recommendations in the OTS Small Business Review, the government issued a call for evidence in July 2011, set up a number of stakeholder working groups, and commissioned external research into the attitudes of small employers. It was announced the government would wait for further progress on planned operational changes to the tax system before formally consulting on integrating the operation of income tax and NICs.

**10.37** Some have told us the complexities that we highlight are subsumed into the software that people use, and for the vast majority the system is understood and working well. But in meetings the OTS have held on the employment status project, the matter was repeatedly raised. We heard that the boundary between employment income and self-employment income was artificial, and that an individual should be assessed to tax on income from working less expenses, to produce the same result. As one stakeholder put it: "Whether individuals are employees, self-employed or agency workers, the amounts received for their services are still income – why can't it all be taxed/NIC'ed at the same rates?"

**10.38** This could be achieved through the merging of tax and NICs, or as a preliminary step, to align the rates of national insurance between the two statuses. As set out later in the chapter, the opportunity should be taken to fully align the benefits available to each.

**10.39** Apart from the aligning of the employed and self-employed contributions and merging the income tax and NIC systems, there are other routes that could be considered so as to reduce the pressure on the questions of employment status. We summarise them under three headings:

- harmonising contributions for the employed and self-employed
- bringing income tax and NICs together
- tackling employers' NICs

## Harmonising contributions for the employed and self-employed

**10.40** It would seem logical to harmonise both the contributions and the benefits between employed and self-employed. The amounts paid are similar (class 1 vs classes 2 + 4) for most workers, with the same 2% rate applying to income above the upper threshold.

**10.41** This would result in increases in NICs bills for the self-employed. It is estimated by HMRC that the current benefit to the self-employed compared to employees is of the order of £2.6bn; to put this into context, the total NICs revenues from the self-employed is currently about this amount.<sup>179</sup>

**10.42** The compensation would have to be that benefits entitlements are similarly harmonised. To repeat the note from Chapter 3, a table listing benefits available per NICs classes is set out in

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<sup>177</sup> Mirrlees Report Chapter 5 Tax by Design: <http://www.ifs.org.uk/mirrleesreview/design/ch5.pdf>

<sup>178</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/199183/05\\_ots\\_small\\_business\\_interim\\_report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/199183/05_ots_small_business_interim_report.pdf)

<sup>179</sup> Source: HMRC statistics <https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs> and the IFS Green Budget 2015 publication.

Table 3 in Annex H. The reduction and numbers of benefits relying on the contributory principle leave only four that remain available to employees which are not available to the self-employed:

- contributory based job seekers allowance
- statutory maternity/paternity/adoption pay
- statutory sick pay
- state second pension, state graduated pension, state earnings related pension (SERPS)

**10.43** Of these, the state pension is of course by far the largest in terms of cost. However, the proposal for a flat rate state pension payable from April 2016 further reduces the link to paying NICs. This would clearly be a major policy issue and as such we acknowledge that it is outside the OTS's scope, but we have to point out that the way the work force is changing does argue strongly for comparable arrangements for all workers, not least to make it easier to move between the two main states (or carry out both types of work at the same time).

**10.44** There are other issues in the way of this obvious simplification:

- weekly/monthly vs. annual payment basis: to properly harmonise would require NICs to move to an annual cumulative payment basis, in line with PAYE, as the OTS has recommended in the past (we return to this issue below in the argument for general change to NICs)
- cost: we have not been able, given the time available, to consider the costs of such a move. In the past it has been suggested that there would be a significant net cost to the Exchequer (i.e. a benefit to the self-employed) because of increased state pension entitlement. With the move to flat rate pension the figures will alter and our instinct is that the costs involved are reasonably balanced. But the costs to both the self-employed as a whole and to HMRC and the Exchequer would need to be considered carefully.

**10.45** There is also the overall issue that if this increases the tax burden on the self-employed it would discourage investment and/or simply increase the drive to work through service companies or umbrellas.

**10.46** Overall, the OTS recommends a full study into alignment of payment and benefits across the classes of contributors.

## Bringing income tax and NICs together

**10.47** The OTS appreciate that a merger of tax and NICs is a radical proposal, but the number of respondents we have heard calling for this means we have to recommend it again. As before, we stress that we are talking about integration – of definitions, calculations and administration – rather than a full merger of the two levies into one<sup>180</sup>. We fully appreciate that there are significant political and presentational reasons for keeping the two levies separate. The OTS does not underestimate the considerable impact that such a project would inevitably have on HMRC resources. The compensation is that the simplification gains are considerable.

**10.48** The issues that need to be considered are:

- Exchequer impact - the choices on the definition of tax base can significantly affect Government revenue, as already noted above. Since then, the considerable

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<sup>180</sup> Though a full merger was called for at a large number of the meetings we held.



increases in income tax personal allowances have not been matched by increases in NICs starting points – so the cost of alignment will be considerably greater (assuming that the NICs entry point is raised in line with the personal allowance).

- The perception behind a resulting increase in headline rate of income tax – the possible impact on the labour market when true marginal tax rates become clear, although greater transparency is necessary for individuals to make informed decisions<sup>181</sup>.
- Special relief for pensions and pensioners - a sudden increase of 12% in taxation on pension payments would clearly not be acceptable.<sup>182</sup>
- Whether savings and dividend income (other than close company dividends) should have special treatment - again, this income is not currently subject to NICs, but in the case of close company dividends, as demonstrated in tables 1 and 2 in Annex H, this produces anomalous results likely to distort business behaviour.
- Employer NICs - respondents have reported this as a driver in the employment/self-employment boundary. We have already noted that employer NICs are a major source of revenue for the government and return to the issue below.
- Internationally mobile employees - double tax arrangements for overseas social security payments need to remain aligned.

### Steps necessary in undertaking integration

**10.49** Given the Exchequer and perception impacts noted above, it is suggested such an undertaking would need to be broken down into a series of steps, with the first step listed here having the most impact on employment status:

- Treatment of the self-employment - collection of class 2 and class 4 is to be aligned from April 2015 following earlier OTS reviews. Full alignment with employee NICs is called for as the next stage, as discussed above.
- Consistency in the definition of earnings - a key recommendation in our review of employee benefits and expenses: second report<sup>183</sup> was for alignment of the bases on which tax and NICs are calculated.
- If there are to be differences in the bases, these need to be defined. In other words, the presumption is that the bases would be the same unless there are differences for specific reasons. The obvious examples that would have to remain as differences would presumably be pension payments and savings and dividend income.
- Alignment in the calculations - moving NICs to an annual cumulative basis, and assessing per person rather than per employment. A significant barrier to integration is being removed as part of the move to a flat rate state pension, meaning there will no longer be the complexity of contracted out and non-contracted out rates. Therefore it should be possible to enter NICs on forms P45s.
- Aligning reliefs and exemptions across the two systems

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<sup>181</sup> Mirrlees report Chapter 4 Tax by Design: <http://www.ifs.org.uk/mirrleesreview/design/ch4.pdf>

<sup>182</sup> We do have to note that both income tax and NICs have a measure of logic and fairness in the way they treat pension contributions and pension payments. Income tax gives relief for the contributions and balances this with taxing pension payments. NICs gives no relief for contributions – but does not tax pension payments. Either could, in theory, change to the other's method.

<sup>183</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/275795/PU1616\\_OTs\\_employee\\_benefits\\_final\\_report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/275795/PU1616_OTs_employee_benefits_final_report.pdf) Chapter 7

- Abolition of the contributory principle – to facilitate the various alignments. The point being that there will be few actual contributory benefits, once flat rate pensions are introduced – so is the full mechanism of contributory record-keeping worthwhile?
- Integrate class 1 and 1A (and potentially class 1B): the OTS work on employee benefits and expenses raised the question of NICs applying to all benefits in the same way as to ordinary pay. At the time we noted it as a major policy matter that needed to be considered by those responsible for deciding NIC policy, but we noted that having (in effect) only employers' NICs applying to benefits is a cause of complexity and seems increasingly anomalous. We repeat the point here as something needing consideration in the integration of income tax and NICs.

**10.50** The OTS reiterates the recommendations made in the Small Business Review, that merging tax and national insurance would remove many of the anomalies within the tax system, and contribute significantly to simplifying issues around employment status by reducing the differentials.

## Tackling employers' NICs

**10.51** The subject of employers' NICs has cropped up already in this chapter, just as it did in virtually every meeting we held. It is difficult to discuss issues around employment status without referring to employers' NICs, which are cited as a major driver for the problems. Businesses want to manage the risk of exposure to employer NICs; avoiding the need to pay such NICs can potentially increase pay, or simply reduce costs. The issue is a classic 'elephant in the room'; how can that elephant be tackled?

## Abolition of employers' NICs

**10.52** We are well aware that there are, as one official put it to us some time ago, '60 billion reasons why one cannot abolish employers' NICs' (i.e. that is the order of annual receipts in pounds to the Exchequer). We do, though, have to note that countries such as Canada, where there are no equivalents to employers' NICs, do not see the level of disputes and problems that the UK does.<sup>184</sup>

**10.53** However, simple abolition is clearly a non-starter for simple fiscal reasons.

## Moving employers' NICs to employees

**10.54** We have had it suggested that employers' NICs could be 'abolished' by increasing the employees' rate by 13.8 percentage points. This would clearly be a massive increase in employee NICs although we appreciate that there is an argument that wages would rise by the equivalent amount (as employers would no longer have to pay NICs). It would make the tax burden more transparent but from the point of view of our current project it would probably exacerbate rather than reduce the pressures around employment status, as there would be an even greater and more obvious incentive to work as self-employed (directly or through an intermediary).

## Introducing a 'contractor's rate' of NICs

**10.55** If abolition of secondary NICs is a non-starter, what about imposing the equivalent on non-employees? Clearly that would be a huge impost on many self-employed people and would immediately raise major issues of fairness. It would penalise the self-employed, who would have

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<sup>184</sup> As we noted in our Competitiveness report, Canada has a policy of avoiding tax differentials between the employed, self-employed and personal companies as far as possible.



to pay it; they would not see any of the benefits of employment (i.e. employment rights) which, although not funded by employers' NICs, are sometimes seen as linked.

**10.56** Unsurprisingly, although in a number of meetings this route was acknowledged as an indirect way of solving the employment status issue, it was generally seen as distasteful.

**10.57** In some of our meetings, there was support for a modest (i.e. much less than 13.8%) 'Contractor's NICs' levy, **to be paid by the hirer**. This would reduce the cost differential between the hiring routes and could be priced into the cost of doing business, it was suggested. If this is to be pursued, there would be some major issues to consider, including who it would apply to: all self-employed? Would it apply to those hired through agencies – instead of current arrangements?

**10.58** Although it would add to costs (and administrative burdens), this was seen as a way of delivering certainty for hirers: the point being that paying the levy would mean that there would be much less risk of HMRC proceeding against the business for wrongly categorising the individual. There would clearly have to be some protection for HMRC built in – perhaps that the business would have to be able to show that they took 'reasonable care' in deciding what rate of NICs to apply.

### Improving IR35

**10.59** Like expenses, IR35 is strictly outside our terms of reference as other work is going on into the subject through the IR35 Forum, itself a product of an earlier OTS review. However, inevitably it is a subject that came up regularly in our meetings. The general verdict is that IR35 is not working and, with its focus on individual assignments, is unlikely ever to work practically. It is also widely seen as unenforceable by HMRC. Many of the people commenting on IR35 want it to work 'better': but this is in terms of it becoming an easily-applied tool to penalise clear 'disguised employment', with genuine freelancers left without the threat of IR35 hanging over them.

**10.60** It is difficult for us to say more on IR35 other than to reiterate that it needs a solution in terms of a less burdensome way of working.

### Imposing NICs on dividends from some companies

**10.61** This is an anti-avoidance route that was raised in many meetings. It was always linked to IR35, the point being made that if NICs were imposed on dividends from personal service companies, there would be no need for IR35. Like the other major changes to NICs noted in this section, it is clearly a policy matter but it does deserve noting. Close company apportionment was aimed at similar mischief, but was repealed in 1989.<sup>185</sup>

**10.62** At the same time there are obvious difficulties:

- how to identify which companies are affected: the target might be seen as personal service companies but how would they be defined? Companies with a small number of shareholders might be used as a proxy – but that would catch many entrepreneurial businesses.
- compliance: collecting the NICs might well prove difficult from small companies.
- could umbrella companies be brought into the NICs net?

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<sup>185</sup> In outline, this required close companies to distribute a proportion of their income – the subject of an involved calculation but at one stage half their net trading and rental profits plus all of their investment income – or have their shareholders taxed as if there had been a distribution.

- would you require minimum salary levels from some companies?<sup>186</sup>

**10.63** The final bullet above is a variation on the previous suggestion and has similar overtones of the old close company apportionment idea. It has been suggested as a possible route by those advocating the 'Freelancer Limited Company' which we explore further in Chapter 12. The main problem is in defining and monitoring the salary level.

### **Pension contributions and NICs**

**10.64** Finally in this section we need to acknowledge the issue highlighted by the Institute for Fiscal Studies in their Green Budget 2015 publication<sup>187</sup>: that contributions to pension schemes by employers are excluded from earnings for both employer and employee NICs. Employee contributions do not get a similar exclusion<sup>188</sup>, so that the pay before employee contributions is the figure on which NICs are charged. This is a point noted in a handful of our meetings but was generally regarded as simply part of the pensions savings fabric and a reasonable encouragement to save in pension funds. In the context of our report we do have to note that the self-employed do not receive a comparable NICs benefit for some of their contributions. Changing the NICs treatment of pension contributions might allow some changes to the overall rate of employers' NICs.

**10.65** Tackling employers' NICs is the key way of taking the heat out of the employment status issue. Many have suggested that unless it is tackled, the issue will remain insoluble in practice as there will always be a major differential (and so incentive) to operate as self-employed (directly or through an intermediary). There is no easy way to abolish employers' NICs, but an important first step would be to increase transparency around them and hence the understanding of the average individual of how much is being paid in what is, in effect, a payroll tax. That might provoke a better-informed debate on how best to reform the tax.

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<sup>186</sup> There is some legislation already in this area: section 447 ITEPA 2003. However, in considering this, the Paymaster General's comments in the Finance Bill (No 2) 2005 debates are relevant: "...the purpose test introduced by this section has been carefully designed to target complex, contrived avoidance arrangements that are used mainly to disguise cash bonuses". In other words, it does not impact small businesses that do not use contrived schemes.

<sup>187</sup> See [www.ifs.org.uk](http://www.ifs.org.uk)

<sup>188</sup> Unless a salary sacrifice arrangement is entered into.



# Deduction of tax at source

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**11.1** Requiring the payer to deduct tax from payments is a cornerstone of the UK tax system. PAYE/NICs and bank interest are the everyday examples but in many meetings the subject of the Construction Industry Scheme (CIS) was raised. Although people often wanted to discuss problems with the system, the context was usually that a system that required deduction of tax at source from payments of income had merits in many directions.

**11.2** Payments to the self-employed are not subject to any deduction at source, apart from CIS, though the income generated is naturally within the income tax net. In debating routes to 'solving' the problems created by employment status disputes, the idea of changing this and imposing some withholding on payments to at least some non-employees was often mooted. The arguments were in broad terms:

- the system could be designed to make it easy for hirers to decide whether to deduct or not, potentially giving them a 'safe harbour'
- deducting tax would ensure the income is subject to some tax and would be logged on HMRC systems
- proper integration with the wider tax system would mean that the worker would end up paying most of their tax liability through the year rather than afterwards

**11.3** The OTS's view was that this system had merits as a possible route to improve the current system and was worth examining. We have therefore spent some time looking at the issues that arise and our conclusion is that the route is attractive.

**11.4** This may be seen as a route that will appeal more to businesses/employers than individual workers. But it could deliver greater certainty and ease the burden of paying taxes.

## Comments on CIS

**11.5** CIS is outside the remit of the OTS's project so we have not examined the subject, but we have naturally listened to and noted what we have been told. The problems cited to us can be summarised as:

- defining who is affected
- calculating the amounts – as deductions are made for goods/materials supplied
- record keeping and returns
- getting credit for the tax deducted
- cash flow, especially if the deductee has their own staff to pay
- the sometimes draconian impact of the penalty system (also raised with us during our recent Penalties project<sup>189</sup>)

**11.6** There is also a possible problem deriving from CIS's origins. It stems from an aim of controlling evasion and the hidden economy. Thus it is tarred with an image of 'cracking down':

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<sup>189</sup> See <https://www.gov.uk/government/publications/tax-penalties>

could this make those affected see it in a negative light and HMRC police it too rigorously? At the same time, HMRC remain concerned that parts of the construction industry is 'high risk'.

**11.7** If a 'CIS writ large' is a possible route for a wider population of taxpayers, these issues must be kept in mind.

**11.8** We are aware that HMRC is looking separately at the operation of CIS – hence its exclusion from our Terms of Reference.

## What is the problem?

**11.9** This project stems from the problem of the dividing line between employees and self-employed. In tax terms there is a stark division:

- the employee is on the payroll, PAYE operates, employers' NICs are due
- the self-employed sort their own tax out and pay lower NICs (with no employers' NICs being due)

**11.10** The risk for business in getting this wrong is that they end up with a PAYE/NICs bill if they pay someone gross who is found not to be self-employed. As the OTS has repeatedly been told, a bigger issue is becoming exposed to employee rights. Many businesses therefore 'manage' the situation by requiring people to work through intermediaries: personal service companies, agencies or other forms. This tends to manage the tax exposure though recent employment cases suggest that it will not completely manage the wider employee rights exposure.

## A possible tax solution

**11.11** Focussing on income tax alone for the moment, the concept would be that all those who are paid for work but who are not paid through the payroll are paid subject to a withholding tax. This would be subject to an initial simple test that would focus the deduction on those who are supplying labour rather than goods.<sup>190</sup>

**11.12** Rather than a blanket requirement to deduct from all those supplying labour, it would be possible to widen the two-way division:

- employees – remain on the payroll with full PAYE (and NICs)
- self-employed – those clearly self-employed (to be discussed, but could potentially include significant firms) can be paid gross
- all others – who might be termed workers or contractors, have a set proportion of their payments deducted and paid over to HMRC as payment on account of their own tax liability.

**11.13** The concept needs to be tested against the problems people raise in the context of CIS.

## Defining who is affected

**11.14** The simple route of requiring all those not on the payroll to have withholding tax applied is relatively easy in terms of identifying who would be affected. As noted, there would need to be a test so that the deduction is focussed on those supplying labour rather than goods.<sup>191</sup>

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<sup>190</sup> A model might be the Australian one of 'wholly or mainly labour' (see Chapter 5).

<sup>191</sup> The CIS system is discussed below.

**11.15** If the three-way split route is used, the immediate reaction may well be that we have just doubled the problem: instead of one dividing line (between employed and self-employed) we now have two:

- (i) between a (employed) and b (other)
- (ii) and between c (self-employed) and b (other).

**11.16** This need not be the case. The first divide – between a and c – is self-policing. If someone is on the payroll, fine. If not, they may be exposed to the withholding tax.

**11.17** The dividing line between b and c is potentially the problem one. However:

- the default would be that withholding tax is applied unless the payee is clearly self-employed
- that status would have to be evidenced (see below)
- the tax deducted is not an absolute increase in the tax bill, but a payment on account
- the key would be that the withholding tax would be credited to the taxpayer's account under a form of Real Time Information, and would be treated as general tax, not a separate levy

**11.18** The payer would need to be presented with clear evidence of the payee being self-employed not to deduct tax. The default would be that tax is deducted.

**11.19** Evidencing self-employed status probably immediately conjures up visions of the CIS certificate system used in the early days of that system. Nowadays we have to look to a digital solution. The key is that the individual would have to quote:

- National Insurance Number; and/or
- Unique Taxpayer Reference

to be paid gross. The payer would have an online check system to HMRC to confirm that the individual can be paid gross. The default would be that tax is deducted and remitted to HMRC to be credited against the national insurance number, so any lack of a unique taxpayer reference would again be self-policing.

**11.20** This withholding mechanism would only apply to payers who are in business themselves: thus payments for domestic services would not give rise to a withholding tax, given that such a route would then mean the householder would have to remit the money to HMRC and make returns. This would clearly be inappropriately burdensome.

## **Is this payments for services – or goods and services? And expenses?**

**11.21** The focus of this route would be to have withholding tax apply to payments to individuals for their services. CIS recognises that many of those affected will also be supplying goods, so allows them to deduct their cost before tax is deducted. That adds complexity. Could this new route simply apply to any payment at a set rate, without deduction?

**11.22** From a simplification point of view, it would be better to try and build a simple dividing line. The Australian route already mentioned does manage this with a 'wholly or mainly labour' criterion. This would ensure that 'supply and fit' type arrangements fell to be treated as supply

of goods rather than labour and so payable gross.<sup>192</sup> It is also possible that such mixed supplies would fall into CIS rather than the new withholding tax.

**11.23** There may be lessons to draw on from VAT: although the same VAT rate applies to supplies of goods and supplies of services (so the distinction can be academic) ideally the same dividing line would be used for both VAT and the new withholding tax.

**11.24** A similar issue arises in relation to expenses incurred by the worker. These would presumably mainly be travel and subsistence. There are self-evidently two possible routes; taking a payment of 100 plus 10 expenses as an illustration:

- deduct tax from the 100 only
- deduct tax from the full 110

**11.25** Simplicity would dictate that the second route is followed, as the payer would apply the withholding tax to any payment made. There would be no need to validate the expenses in tax terms, though commercially the payer would presumably only be paying for them if they were in line with the terms of the arrangement. However, that does mean the individual is not getting immediate reimbursement for valid expenses and may be out of pocket for some time. This is clearly an issue to explore further if this route is explored, testing such issues as:

- what level of expenses are potentially affected, bearing in mind that the hirer would in many cases not be paying for travel (as effectively ordinary commuting)?
- what risks and burdens are there in allowing the hirer to assess their validity?
- how significantly would the worker be affected by a deduction from the expenses?

## What about payments to companies and partnerships/LLPs?

**11.26** Excluding companies and partnerships from the withholding tax requirement risks giving a further incentive to operate through personal service companies (or husband and wife partnerships). But would it be sensible to require tax to be deducted from a payment to a major plc or large professional services firm?

**11.27** The first point to make is that the large firm (and for that matter the plc) would easily pass a 'self-employment test' to enable payments to be made gross. But what would the dividing line be, and how would it be evidenced?

**11.28** We have already referred to the Australian 'wholly or mainly labour' test and that would probably be a starting point for this process. That would not exclude the professional services firm, nor a plc consulting firm, from the withholding tax requirement. The test could stop at that point: such large firms would have paid some of their tax liability for the year on account and it would be creditable against their final bill in the same way as it would be for a sole trader.<sup>193</sup>

**11.29** If it were instead decided that the withholding tax would operate in a way that excluded established significant businesses, it would have to incorporate various tests. The goal in mind might be that an individual operating through a personal service company or small partnership could not escape the withholding tax.

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<sup>192</sup> If someone is supplying goods then they may well be able to establish self-employed status easily.

<sup>193</sup> However, one issue that would arise would be the mechanics of crediting a deduction against a partnership's tax bill, given that the partnership does not pay tax which is instead a liability of the partners. A rule could be framed simply to allow the firm to allocate the credit as they see fit to their partners to help settle their own liabilities.

**11.30** The dividing line would need to be easy to operate. If we are trying to apply the withholding tax to payments that are in effect for an individual's services, that might suggest that to qualify for gross payment, the payee when issuing an invoice, has to include on it a statement to the effect that they:

- (i) are a company with (say) 5 or more shareholders; or
- (ii) are a partnership with (say) 3 or more partners; or
- (iii) for other companies/partnerships, that they can be paid gross because they would definitely qualify as self-employed if engaged directly

**11.31** The last test might be seen as IR35 in effect, but it moves the potential certificate to the invoice/payment stage and requires the organisation to apply a simple self-assessed test.

**11.32** The consequences must be understood:

- the default is that tax would be deducted
- any tax lost is not an extra bill: just a payment on account.
- that tax would be creditable against future income tax **or, for a company, corporation tax**<sup>194</sup> liability
- the deduction could potentially replace IR35 for personal service companies, in that the business would be paying some tax and have a better audit trail established for HMRC to follow up

## Should agencies and umbrellas be in the withholding tax net?

**11.33** Again, the simple answer to the question would be 'yes'. Similar arguments apply as to the company/partnership situation. The worker will simply have had some tax deducted which can be credited to their account with HMRC through their national insurance number.

**11.34** However, agencies are already required to treat agency workers as their employees and deduct PAYE at source<sup>195</sup> – so the need for the withholding tax falls away.

## What rate of tax would be deducted?

**11.35** This is not a PAYE-like attempt to get a precise tax bill deducted from the payment. It is a true payment on account. So the rate could be set at anything, but 15%<sup>196</sup> might be used as a rate to assess it in greater detail.

**11.36** NICs could also be taken into account in setting the rate but crediting NICs withheld against NICs due would add considerable complexity given the way the NICs system currently operates.

**11.37** It would be possible to devise a system that has different rates of tax for different situations. The problem is that imposes further administrative complexities. Thus the OTS recommends that any development of this withholding tax route is on the basis that a single rate is used.

**11.38** Because this is not a system that gets to an exact tax amount, there would be a risk that some taxpayers would fail to report their income and pay any additional tax due. However, the

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<sup>194</sup> Including quarterly instalment payments

<sup>195</sup> See sections 44 et seq ITEPA 2003

<sup>196</sup> Or 75% of the basic rate of income tax.



withholding tax route would at least ensure that HMRC received records of such payments – and would accordingly be in a better position to pursue defaulters than at present. There is a bigger potential issue with the low paid who might need an arrangement to repay in year.

**11.39** The consequence of using a withholding tax is that many self-employed taxpayers would have paid much of their tax liability through the year. The need for the existing system of payments on account would fall away from such people, leaving a single ‘tidy up’ payment at 31 January after the year end

## Lessons from abroad

**11.40** A number of countries use a withholding tax on some payments to contractors. We have noted some in Annex I but it is worth expanding here on the Irish situation.

**11.41** The Republic of Ireland has long had a PAYE system patterned on that in the UK, but there are in addition two withholding regimes in respect of payments made for services to people who are not employees. These are Relevant Contracts Tax (RCT) and Professional Services Withholding Tax (PSWT):

**11.42** RCT is a withholding regime applied to contractors in the forestry, construction and meat-processing industries, industries seen as having a poor past compliance record. Deductions are made at 35% initially.

**11.43** PSWT is deducted at 20% from payments made by Government bodies, health boards, state bodies, local authorities and the like from payments made for professional services. “Professional services” are very widely defined. They include medical, dental, pharmaceutical, optical, aural, veterinary, architectural, engineering, quantity surveying, accounting, auditing, financial, marketing, advertising, legal and geological services and also certain training services.

**11.44** The RCT has clear overtones of the UK’s Construction Industry Scheme. There seems to be no suggestion of extending it beyond construction, meat-processing and forestry operations: it seems to work reasonably well for these industries in principle and is accepted. The RCT was revamped a few years ago so depending on a businesses’ tax compliance history, the 35% rate can abate to 20% or even 0%.

**11.45** RCT has now moved to an online platform which for some is more complex: it is apparently easy for a principal contractor to miss a step and face a penalty. However, the move to an online system eliminated around a million pieces of paper, which was accepted as a huge improvement. Interestingly, a subcontractor’s compliance history can be reviewed in ‘real-time’ to determine their appropriate withholding rate.

**11.46** The PSWT was brought in 1987, primarily as a way to accelerate cash to the government.<sup>197</sup> The OTS understands that there is no suggestion of extending the PSWT beyond payments by public bodies. From discussions with contacts in Ireland, the OTS understands that concerns with its operation include:

- Businesses only receive 80% of the fees due to them, but this also applies to any expenses reimbursed so it has a cash-flow impact. A credit for this tax is claimed when the business files their return after the end of the year. There have been calls that tax compliant businesses should be able to have a zero withholding rate to alleviate cash-flow concerns.

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<sup>197</sup> More information on its specifics is available here. <http://www.revenue.ie/en/tax/pswt/>

- There is a process to obtain an ‘interim refund’ but it is a complicated calculation for an average business. In addition, individuals starting in business cannot claim the credit in their first year of operation they have to wait until their second year.<sup>198</sup>
- The system remains heavily paper based, including issuing, retaining original claim forms, reissuing and processing forms and refunds. There have been regular calls for the system to move online.
- If a non-resident firm supplies a service to an Irish state body, even though they may not set foot in Ireland, they suffer the withholding tax and have to go through a lengthy refund process.
- While obtaining the tax upfront is merely a timing benefit to the Exchequer, as it is creditable or refundable, they are reluctant to let this go.

## Wider issues

**11.47** A withholding tax is only an income tax solution and a solution in terms of ensuring some tax is paid on account and ensuring the payment is within HMRC’s vision. It might be seen as a weapon against evasion.

**11.48** The rate could be set with regard to NICs due, but trying to credit NICs deducted via the withholding tax against the NICs actually due may well make the system over complex. Also, it does not seek to solve the problems created by differing NICs rates applicable to different ways of working. (We discuss these in Chapter 10.)

**11.49** As employee rights are a significant issue for both business and individual, the ideal solution might be that this route would lead to some defined, but limited, employee rights. In other words, there would be some gain for the worker and at the same time the hirer would know that their exposure was controlled. This is attractive in concept but it is questionable whether any sort of agreement could be reached that could limit employment tribunals.

**11.50** Introducing a withholding tax would have an impact on the existing CIS scheme. Probably the two systems would operate side-by-side initially but there would be possibilities of either:

- Combining the two systems in due course, so there is one simple withholding tax system for those supplying their services, or
- Leaving CIS in place but evolving it to apply to situations where goods and services are supplied and so permit a deduction under controlled circumstances for the cost of goods supplied in calculating the deduction applied.

## Assessing impacts

**11.51** There are three – or possibly four – parties to consider:

- Businesses
- Individuals
- HMRC and Government

**11.52 Businesses:** they will have to decide whether to apply withholding tax, report payments made including the requisite ‘markers’ (presumably national insurance numbers). Reporting would presumably be through an expanded Real Time Information system. Although this does

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<sup>198</sup> There is a process to make a “hardship claim” but it is difficult to claim.

mean an additional burden, the payback is certainty: the business knows it has complied with everything it needs to do and it has in effect passed the problem to HMRC and the worker.

**11.53** We have discussed the concept with a range of businesses and have received widespread support for it. Many have been clear that the additional burden would be minimal and that overall they see it as a gain – a price well worth paying, in other words. Although no doubt there would have to be a penalty for certain misdemeanours in applying the system, the business should have a ‘reasonable care’ defence: i.e. they took reasonable care in assessing whether to apply the withholding tax. It is also worth noting that with the new reporting requirement under the onshore agency rules a simple general reporting requirement might actually reduce complexity.

**11.54** It is possible that some businesses might decide to apply withholding tax to all payments, in the name of simplicity. Would that really be a concern? If their people felt they were being unfairly treated by such a system, that would create a problem for the business – who might be forced into operating the withholding tax properly. But as this is just a withholding tax, is it such a problem? If it is felt to be a real concern, then a requirement within the system to take reasonable care in applying the system should mean that they have to try and apply the rules properly; in any event, the withholding tax would only be relevant for those who are definitely not employees. Any employees would be on the payroll automatically.

**11.55** Some businesses will be subject to deduction of tax at source. For tax-paying businesses, that tax should be treatable as a payment on account of their tax liability for the year. Importantly it must be creditable against corporation tax. Businesses that do not have a tax liability for the year – examples would be charities, loss-making businesses and local authorities – would presumably be able to reclaim the tax deducted.<sup>199</sup>

**11.56 Individuals** (and any intermediaries they work through): they have additional work to do to prove entitlement to be paid gross. But the tax deducted if they cannot establish that status is not penal. Depending on how it is applied, the withholding tax could be a route that means there is no need to worry about IR35 for those working through companies. The key is that the issue around how to work and be paid is given more profile. For most of those who have tax withheld, the need to make payments on account during the year would drop away, leaving a single payment of residual tax at 31 January after the year end.

**11.57** There is a potential impact on the low paid and indeed loss-makers, in that someone who will not have a liability to tax for the year could lose tax by deduction, which would have to be reclaimed after the year end. This would need to be assessed as to its significance; could there be a route for repaying tax on an interim basis during the year? If HMRC systems are properly operating in real time, why would that not be possible?

**11.58 HMRC:** businesses pass the problem of deciding whether someone is truly self-employed to HMRC. But is that much different to now? The business has to do a certain amount of work to test the basic assertions and will supply information to HMRC in a useable format.

**11.59** Would this route increase HMRC administration? As HMRC will have to log and allocate the deductions made, that does suggest extra work for them. But this is undoubtedly a solution for the digital age. Real Time Information (RTI) is already delivering considerable data in real time to HMRC about deductions made and these are married up automatically against employers’ and employees’ tax records. Why would extending such a concept be so much of an additional burden? It would certainly fit with the idea of pre-populating tax returns as far as possible and seems to be an indicator of a modernised tax system. Overall, any increased burden seems a

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<sup>199</sup> Though many of these businesses would presumably be able to file for gross payment if the differential route of withholding tax was followed.

price worth paying for the greater information flow and increased monitoring of possible tax defaulters.

**11.60 Government:** the possible fourth party to see an impact is government – who would see some improvement in cash flow!

## Conclusions

**11.61** The idea of a withholding tax is promising but the OTS does not suggest that we have fully assessed it. There is a good deal of work to do if the idea is to be turned into a workable route. We believe it could be a simpler route and provide an indirect solution to at least part of the problem created by employment status. It is not a full solution in that NICs differentials still need to be considered, as do employment rights. There are obvious potential problems with operating such a system, many of which are demonstrated by the Irish PCWT, but there are equally opportunities to learn from others' experiences. In particular, the OTS sees it as axiomatic that any withholding tax system would be an online system with fully 'joined up' records to assist taxpayers.

**11.62** It could be simple in that it would be a case of:

- if in doubt, deduct and report
- the tax being credited rather than being lost
- testing whether it would be applied to all service providers or differentiating in some way for significant businesses
- whether to allow for goods and expenses (the OTS considers that it should start from the premise that there is no deduction for goods supplied or expenses)

**11.63** Accordingly, we recommend it as a route to be fully investigated, defined and assessed.



## Introduction

**12.1** In tax terms, employment status is effectively all about deciding between two alternatives: an individual is employed or they are self-employed. Anyone who seems to be in the middle must be fitted in to one or other of the ends of what could be viewed as a continuum.

**12.2** This system of two alternatives can be seen as a traditional view of the labour market<sup>200</sup>. People either worked, normally full-time, for an employer; or they were clearly self-employed: the local plumber for example. But that traditional labour market has changed significantly in recent years:

- More people work part-time, often combining that work with a second or third job, or some activities that are self-employment.
- More significantly, there has been a considerable growth in people working on their own but taking on roles in an organisation for a period, sometimes on an exclusive basis but often whilst working elsewhere. These people may have no desire for traditional employment rights; they are often termed freelancers or contractors.<sup>201</sup>

**12.3** Both of these working patterns display aspects of the employed status but also of the self-employed status. It is often far from easy to force them into one or other status overall. Many freelancers have a succession of contracts that may of themselves have overtones of employment – but at the same time the individual does not become part of the organisation and remains very much on the lookout for new work. It is also sometimes difficult to predict at the start of an engagement whether it will take on the character of employment or self-employment: will it be the only client or the first of many? If individuals and engagers have to analyse all activities separately, the result can be administratively complex all round. It is also a potential source of disputes and leads many to operate through a personal service company – though that may only shift the argument to ‘IR35’.

**12.4** Some have suggested that the answer to this growing problem is to recognise in the tax system a ‘third way’ between employed and self-employed. This would acknowledge that:

- some workers do not fit easily into either of the two basic positions; so
- they should have a modified set of tax rules that apply to them

**12.5** The objectives in setting up a third way status would be to:

- resolve, or avoid, arguments
- provide a safe and certain status and set of tax rules for such people
- acknowledge the validity of this way of working as distinct from the traditional employed or self-employed routes
- reduce administrative burdens all round

<sup>200</sup> It is worth noting that for many years, Schedule E only included government employees and employees of public companies. All other ‘employees’ were taxed under Case 2, Schedule D. See Stephen Dowell’s History of Income Tax, Volume 1 page 116

<sup>201</sup> See Chapter 1 for analysis of the workforce changes

**12.6** There are two sources of people who might fall into the third way. These overlap but are at the same time distinct in terms of origins and drivers:

- the freelancers/contractors referred to earlier, and who might be seen as people who have chosen this route of working and want certainty over their status
- ‘limb b’ workers<sup>202</sup>, who are more likely to be people who feel they should be on the payroll of the organisation they are working with.

## How to structure the third way

**12.7** There are two alternative routes that could be taken if this route is to be developed:

- A new type of legal entity is created for the individual who operates in this manner; or
- The third way is simply a status accepted in the same way as employed/self-employed, possibly via an election.

**12.8** The new vehicle could be a ‘single person limited company’, i.e. a development of the traditional limited company. The alternative is that it is a new ‘freelancer vehicle’ (a ‘Freelancer Limited Company’), with some of the characteristics of the limited company but essentially a new idea.<sup>203</sup>

**12.9** It is already possible to establish a third way by operating through a personal service company. But the point of formalising a new status into a new vehicle would be to give a clear result, in tax terms, and ideally avoid simply moving the arguments to those around IR35.

**12.10** If the third way were established by a status rather than a separate legal vehicle, it might be something for which the individual could elect.

**12.11** One key issue is whether the third way could be used by someone who was clearly employed. The OTS’s assumption is that this would not be acceptable: it could not be used to disguise employment. That may be possible to police if the status/election route is followed (there would have to be evidence that such an election would reasonably represent their status and the person would have to be operating in a manner commensurate with the putative third way). If the Freelancer Limited Company route is followed, then there is a risk we are straight back into IR35.

**12.12** Having a set legal vehicle would make the establishment of the third way clearer but would be more bureaucratic. That might be a small price to pay but on the other hand if a simple route can be set up that allows the status via an election, it would be easier for all.

**12.13** The route taken for this third way could also affect whether the new status is for an engagement or for a tax year. Operating through a new type of vehicle would potentially make the individual’s status clearer than if it were something that had to be reviewed for each assignment. It would certainly be simpler if the status was set for a tax year, or until circumstances changed. So if the election route were followed, that election might be an annual one – or at least it would operate until revoked or the individual takes on what is clearly an employment.

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<sup>202</sup> Under section 230(3)(b) Employment Rights Act

<sup>203</sup> BIS have in the past looked at the idea of the single person limited company but have not pursued the concept. More recently, the Freelancer Limited Company concept has been developed by IPSE (the Association of Independent Professionals and the Self-Employed) in particular.

## Tax consequences of the third way

**12.14** If this middle status is to be accommodated by the tax system, those covered by it would have to accept tax consequences that were part way between employed and self-employed. Considering first the separate vehicle route (Freelancer Limited Company or similar), presumably corporation tax would be expected to apply to the profits of the entity. That would mean IR35-type problems over assessing such vehicles to PAYE/NICs.<sup>204</sup>

**12.15** A possible solution to this problem has been suggested by one paper<sup>205</sup> promoting the Freelancer Limited Company idea: the entity agrees to a 'fixed but fair' salary-dividend split, to give some income subject to PAYE/NICs. However, that could be difficult to design (what would be a fair split? Would it be for all such entities or would there be a range?).

**12.16** It may be easier to think of the non-body route. Potentially this means:

- *Income tax*: income would be charged to income tax in the normal way and at normal rates. Payment of the tax liability would have to recognise that PAYE would not be operated; possibly the withholding tax mooted in Chapter 11 would apply, meaning that the individual would have paid much of their tax liability during the year. In such cases there would be a final tax payment to make, potentially at 31 January after the year end. If there is no in-year withholding, some system of more regular payments might be required.<sup>206</sup>
- *Expenses against income*: more generous expenses are often seen as a key incentive to be self-employed. Some business expenses would be appropriate; but the big issue would be whether travel and subsistence would be allowable on the basis that the individual operated from home – or from a succession of places of work. This is something that should be considered as part of the current HM Treasury review of travel expenses.
- *VAT*: if the individual's income is high enough, registering for VAT would be possible in the normal way. But the rule could be set up to say that the person operating as third way was not able to register for VAT (if EU rules permitted this)...or that if they did, their VAT registration would also mean they were categorised as self-employed.
- *NICs*: individuals would pay NICs at a rate between employees and self-employed rates. In Chapter 10 we have suggested that class 1 (primary) and the sum of class 2 & 4 should in principle be the same, and carry the same entitlements. That would seem to indicate that the third way worker would simply pay this new common amount. However, the major question then arises: what of employers' NICs? Should this new route mean that the individual has to pay a proportion of this levy, not to gain any further rights/benefits but as part of the fee for the status? This could be a 'contractor's rate' of NICs. In our various discussions on the subject, many saw this

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<sup>204</sup> It might be possible for a radically different approach to be taken to taxing the new entity. The OTS has in our work on small business looked at alternative ways of taxing the smallest businesses. That led to the introduction of the cash basis rules (our preferred option) but we also looked into radical alternatives, including such routes as a turnover tax. We noted that such systems are in use in some other countries – notably France – for very small businesses. This turnover tax would in effect cover IT/CT and NICs; France's system also covers VAT although that is unlikely to be relevant in the UK with our registration threshold, assuming any new route was designed for the smallest business – 'nano' businesses in the OTS terminology. We have not sought to investigate the idea again but note it as a possible route to consider investigating if the overall concept of a third way is taken forward.

<sup>205</sup> Philip Ross and Andrew Burke "The Freelancing Agenda A Charter & Policy Proposals", September 2014 Labour Finance and Industry Group

<sup>206</sup> Note that if this third way concept is pursued, it is suggested that whatever structure is used would lead to income tax for the individual rather than corporation tax. That would preclude needing to consider taxing distributions from the vehicle and operating IR35 on it.



as potentially a fair price to pay – no doubt assuming it would be well away from the 13.8% rate.

## Double the arguments?

**12.17** The basis of this OTS project is the volume of arguments around the boundary line between employed and self-employed. If a third way is introduced, could that mean two lots of boundaries to argue about rather than one? The hope is that many of the previous difficult cases would fall into the middle ground and so be settled, leaving a smaller number at the margins of both routes.

**12.18** There would be some cases on a boundary, but depending on how the third way was set up, it could be that there is a default status, i.e. that without action to establish one state or another, then employment applies. Also, the tax/NICs differential for the two new boundaries would be smaller than the one old boundary, reducing incentives to artificially move across the boundary.

## Wider issues

**12.19** The consequence of electing for the third way is that the individual would accept as a consequence that they have defined but (probably very) limited 'employment rights'.

**12.20** There are a number of significant issues that would need to be considered in the development of this route. It would be as well to confirm that they would be solvable before starting out.

## Employment rights<sup>207</sup>

**12.21** As well as tax, there would be the question of employment rights. The starting point would be that the status meant no such rights – no redundancy claim, no maternity pay, no holidays etc. But it might be logical and fair to grant certain limited rights, those which in effect are given by the state rather than the employer. That might cover maternity/paternity and sick pay, to be given through the benefits system. It might also be in the ambit of the National Minimum Wage.<sup>208</sup>

## Tax credits/universal credits

**12.22** There would clearly be an impact on tax credits/Universal Credit. The immediate issue would be to determine how third way individuals would be regarded under the system. This may not be difficult as Universal Credit at least focuses on the amount of income from working and is less interested in its origins, though presumably the third way worker would need to make regular returns of income in the same way as the self-employed.

## Pensions auto-enrolment

**12.23** Similarly, how would third way workers fit into auto-enrolment? Probably the answer is that they would not be included – but would that mean they would need rules to ensure that they covered themselves?

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<sup>207</sup> There is an interesting precedent for changing employment rights in line with a move to a different tax status with the recent introduction of Employee Shareholder status: see <https://www.gov.uk/employee-shareholders>.

<sup>208</sup> There are potential links to EU practices here: there are some instances of self-employed workers in other member states being entitled to some rights.

## Does this provide a route to abolish IR35?

**12.24** IR35 has already been mentioned. Its abolition would no doubt be seen as an important and worthwhile result of a 'third way'. In fact, the issue might be better phrased as: the route is only worthwhile if IR35 can be abolished.

## What would be the tax cost of the route?

**12.25** We have not attempted any costings of the route and we readily acknowledge that this will be a key issue. There is clearly a risk to revenues in setting up a route that allows a number of people who might otherwise be taxed as employees to have a different status. Against that, some who might argue successfully for self-employment might be in this middle way. Assessment of the risks to the tax revenues would presumably be a major consideration in any decision on the idea of the NICs contractor's rate.

## Taxation of small business generally

**12.26** In the OTS's work on small business, we suggested there was a need to look generally at the way the smallest businesses are taxed. Our thinking was that considering such routes as a 'look through' basis might solve a lot of problems, in that it would in concept at least eliminate the differing taxing results of a small business conducted as a sole trader compared with that business conducted through a company.

**12.27** Since we made those comments, in our work on Competitiveness we noted that Canada avoids most arguments around the taxation of the smallest business by having as a policy aim ensuring that the tax system does not introduce tax differentials between different ways of carrying on activities.

**12.28** Rather than suggest that a 'Third way' system is introduced directly, we think that there is merit in reiterating our previous suggestion of a full review of the taxation of small businesses. That could cover limited companies, partnerships/LLPs and sole traders, and would have regard to employee taxation.

## Conclusion

**12.29** There are undoubtedly a lot of individuals who work but who do not fit easily into the traditional employed or self-employed system. Establishing a third status that caters for these people is, on the surface at least, attractive. However, the OTS is not convinced it is the best way forward. The key problem is whether this new route (vehicle or election) can arrive at a fair tax charge (so as not to be too expensive for either side) and clarity on employee rights.

**12.30** Introducing a third way risks adding complexity to the tax system. Although the aim would be to give a simple and straightforward route for many who are currently unclear on their position on employment status, it may be that the simplification gain would be outweighed by the additional rules and regulations that would be needed. This would need to be evaluated.

**12.31** On balance we think it is potentially more promising to pursue the other ideas in this report. That said, we do not dismiss the third way and it may be that its proponents can come forward with further analyses to show how our concerns can be addressed.



# List of meetings and submissions

## A

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We are very grateful to the many organisations and individuals that met with us or sent submissions and comments, many in response to the list of questions we published. The following is we hope a complete list of those who have contributed to the project (a significant number of whom both met with us and supplied written comments) but we apologise to any organisation that we have omitted.

All Umbrellas are Equal

Approachable Accountants

Association of Accounting Technicians

Association of Certified Chartered Accountants (East London & Essex branch)

Association of Independent Professionals and the Self Employed

Association of Professional Staffing Companies

Association of Recruitment Consultants

Association of Taxation Technicians

Baker Tilly

BCS The Chartered Institute for IT

Belinda Johnson

Bauer & Cottrell

BECTU (Broadcasting, Entertainment, Cinematograph and Theatre Union)

Bishop Fleming

British Universities' Finance Directors' Group

Department for Business, Innovation and Skills

Business Services Association

Chantry Vellacott

Chartered Institute of Payroll Professionals

Chartered Institute of Taxation (Employment Taxes and Owner Managed Business Committees)

Churches Legislation Advisory Service

Confederation of British Industry

Contractor Calculator

Crowe Clark Whitehill (CCW meeting and clients' meeting)

Deloitte

Devereux Chambers  
Employment Lawyers Association  
Employment Tax Forum  
Equity  
Ernst & Young  
Federation of Small Businesses  
FreeAgent  
Professor Judith Freedman  
Freelancer & Contractor Services Association  
General Practitioners' Defence Fund  
Grant Thornton (meetings with clients in Birmingham, Leeds, Manchester, Reading, London)  
Andrew Harrison  
Hays Macintyre  
David Heaton Tax Ltd  
HM Revenue & Customs policy and operational teams, including Specialist Employer Compliance; Croydon Compliance; ESI unit  
HM Treasury  
Institute of Chartered Accountants in England and Wales  
Institute of Chartered Accountants in Scotland  
David Kirk & Co  
KPMG  
Law Society  
Law Society of Scotland  
Lawspeed  
Leicester City Council  
Low Incomes Tax Reform Group  
Martin Gunson & Co  
Merthyr Tydfil Borough County Council  
MHA MacIntyre Hudson  
Nannytax  
National Access and Scaffolding Confederation  
Oracle  
PricewaterhouseCoopers

Professional Passport  
Recruitment and Employment Confederation  
Road Haulage Association  
Smith & Williamson  
Social Security Advisory Committee  
Stringfellows  
TaxAid  
Tax Help for Older People  
Union of Construction, Allied Trades and Technicians  
UK 200 Group  
Short, Richardson & Forth LLP  
Zurich Insurance

Over 20 individuals sent submissions, e mails or comments.

340 people completed our online survey.

OTS members have spoken at a number of conferences, including ones organised by AAT, ACCA and CIPP, and noted input and contributions from attenders.

In addition, the members of our Consultative Committee (listed in the next Annex) all supplied input personally and where appropriate from the organisations.



# Consultative committee members

B

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David Barton	Baker Tilly
Liz Bridge	Joint Committee of the Construction Industry
Chris Bryce	IPSE (Association of Independent Professionals and the Self-Employed)
Emily Coltman	FreeAgent
Adrian Dixon	HM Revenue & Customs
Asad Ghani	Department for Business, Innovation and Skills
Norman Green	BCS (The Chartered Institute for IT)
John Hampton	Former Personal Tax Manager, BT Group
Craig Harrison	PricewaterhouseCoopers Northern Ireland
Gavin McCann	HM Treasury
Lorraine Laryea	Recruitment and Employment Confederation
Tony Lennon	BECTU (Broadcasting, Entertainment, Cinematograph and Theatre Union)
Sam Mitha	Former HMRC Central Policy / Low Incomes Tax Reform Group
Tony Moody	Department for Business, Innovation and Skills
Roseanne Russell	Law Society and Cardiff University Law School





## C OTS online survey results

**C.1** The OTS ran an online survey from the beginning of December 2014 to mid-January 2015. The survey was advertised on the OTS website and by some organisations, for example the ICAEW and BECTU. The results discussed below were extracted at 13 January 2015 when 340 individuals had completed the survey.

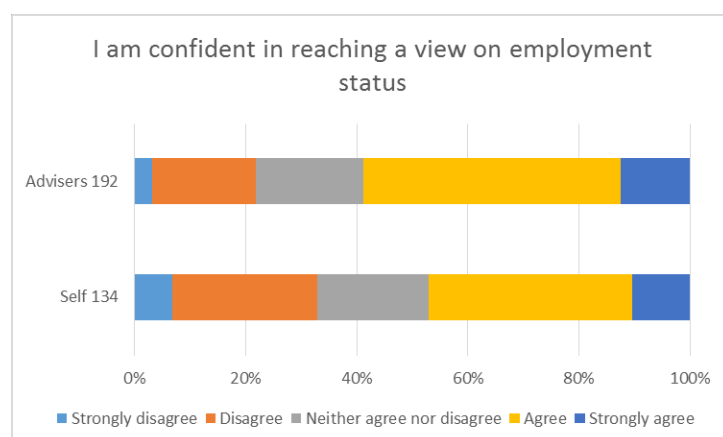
**C.2** Respondents were asked to categorise themselves “why do you mainly find you need to determine employment status?” with the outcome below.

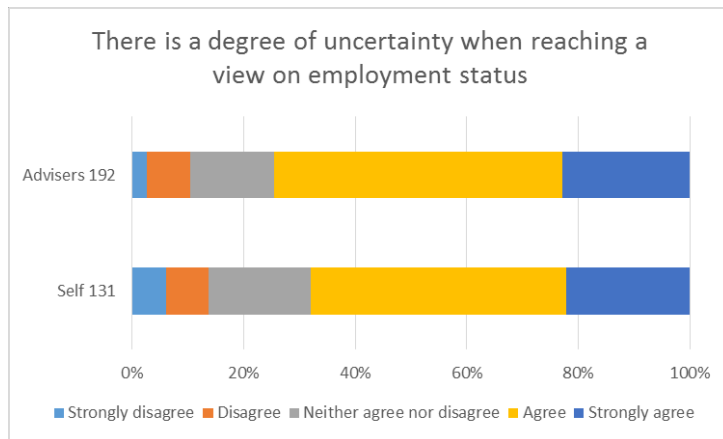
**Table 12.A: Why do you mainly find you need to determine employment status?**

	Response	%
To determine my own tax position	138	43
To clarify an individual client’s tax position	89	27
To clarify the hiring organisation’s tax position	66	20
To assist with related issues such as employment rights	13	4
As part of planning to reduce tax liabilities for an individual	12	4
As part of planning to reduce tax liabilities for the hiring organisation	7	2

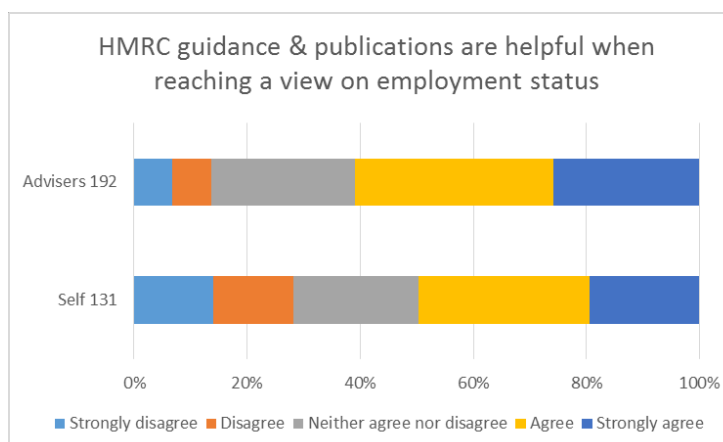
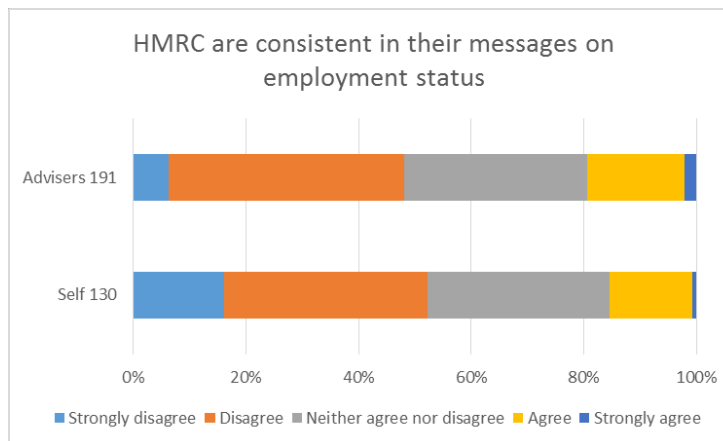
**C.3** For the remainder of this summary responses have been allocated into “Self” - the first category above, and “Advisers” - all the other categories above. Respondents did not all answer all the questions so the figures below may be less than those implied by the total responses above.

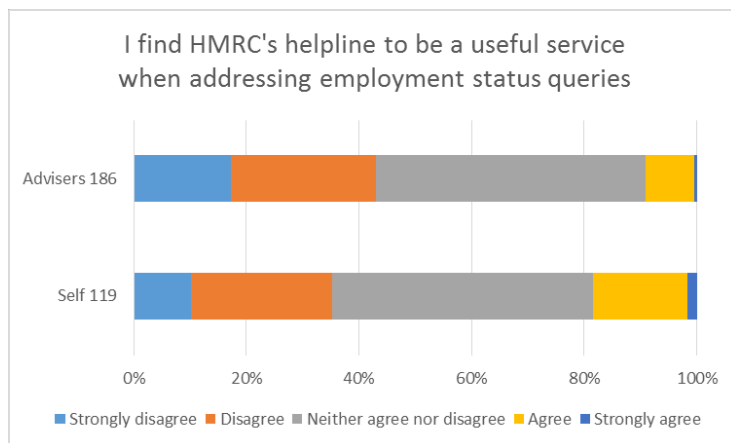
**C.4** In the main the respondents are confident in reaching a view on employment status, though overwhelmingly they consider that there is uncertainty in the process.



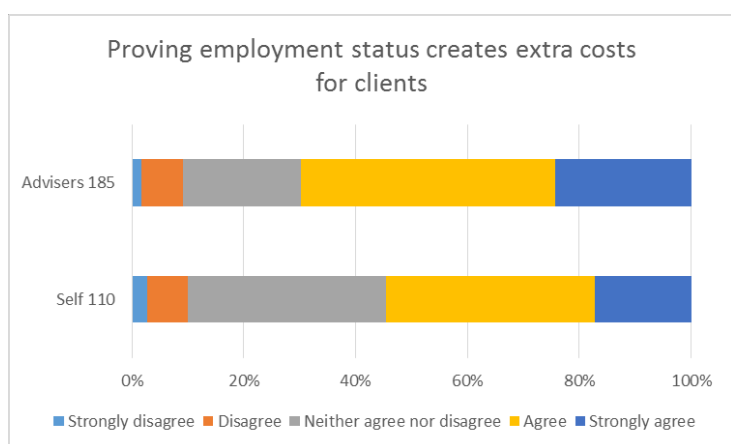


**C.5** There is little enthusiasm for the consistency of HMRC’s messages, and while the view of HMRC’s guidance is generally favourable, HMRC’s helpline receives less support.





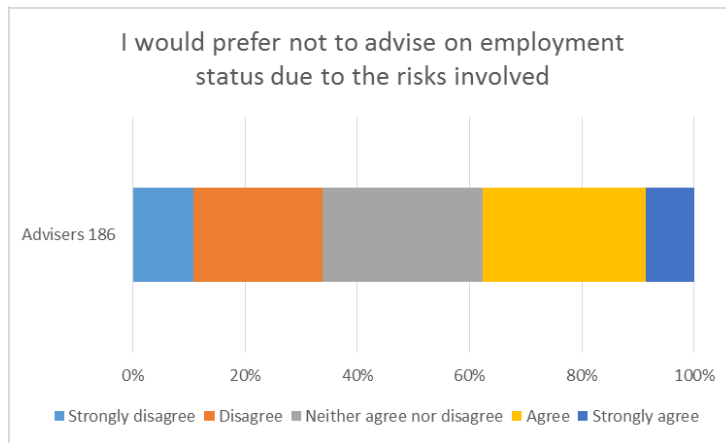
**C.6** There is a widespread view that proving employment status creates extra costs for clients.



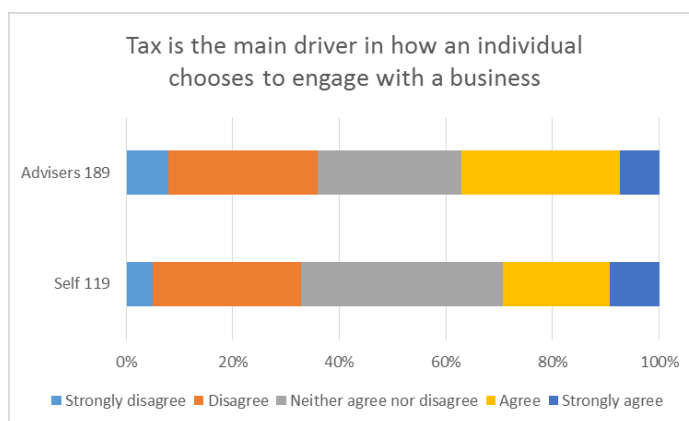
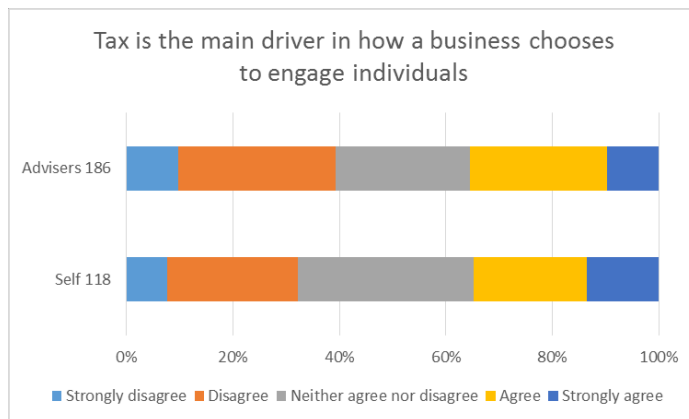
**C.7** Amongst advisers there is not much positive enthusiasm for this type of work; perhaps this is linked to over half of advisers regarding employment status, when compared with other matters on which they regularly advise, as “the most difficult” or “above average difficulty”, giving the following reasons:

**Table 12.B: Advisers who consider employment status difficult: reasons**

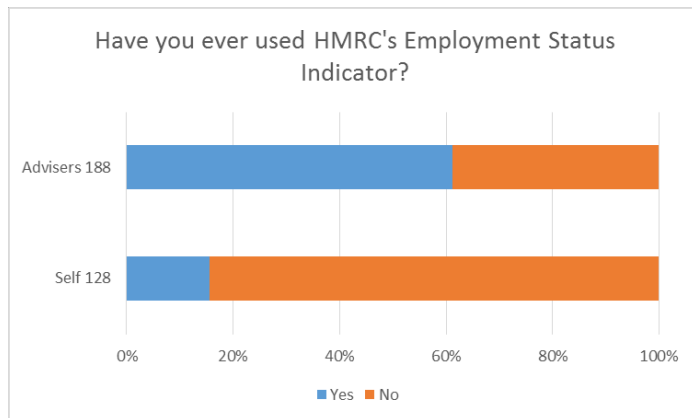
	Responses	%
The complexity of the area	68	59
The level of guidance provided by HMRC (compared with other areas)	41	36
The lack of clear legislation (compared with other areas)	75	65
The level of understanding of the area by my clients/the individuals involved	60	52
My own understanding of the area	16	14
Other	17	15



**C.8** Tax is viewed as a significant driver in engagement choices for businesses and for individuals, though individuals describing the motivation of individuals are less convinced of this.



**C.9** HMRC’s Employment Status Indicator (“ESI”) is surprisingly little used by individuals in relation to their own affairs.

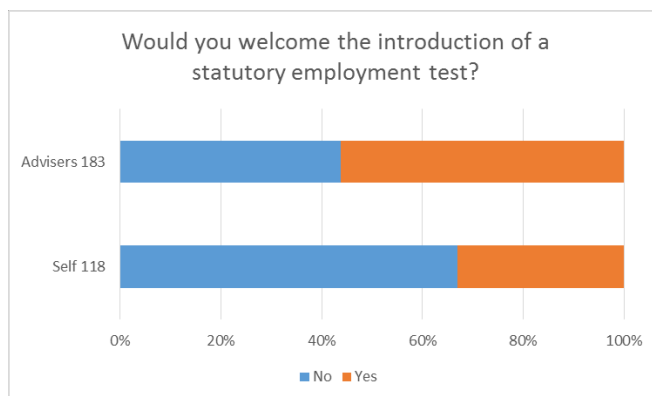


**C.10** When asked “what would encourage you to use the ESI” respondents (combined individuals and advisers) gave the following suggestions:

**Table 12.C: What would encourage you to use the Employment Status Indicator?**

	Responses	%
More publicity around the use of the tool	121	46
Clearer questions within the tool	57	22
Clearer “Help”/explanations of the questions within the tool	56	21
Greater transparency around how it arrives at the results	102	39

**C.11** While 56% of advisers favour a statutory employment test, 67% of individuals concerned with their own status are opposed to the concept.



**C.12** 87 advisers commented on a statutory employment test. Reflecting the split in views on the desirability of a test, some referred to the clarity it would bring, yet others believe that case law gives greater clarity than the current style of legislation; they regard with suspicion the potential introduction of bias into a definition and express concern about increasing bureaucracy.

# Employment status

## D legislation and case law

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### Employment Rights Act 1996

#### Section 230 Employees, workers etc.

#### [Section 230 is applicable to section 54 National Minimum Wage Act]

- (1) In this Act “employee” means an individual who has entered into or works under (or, where the employment has ceased, worked under a contract of employment.
- (2) In this Act “contract of employment” means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing.
- (3) In this Act “worker” (except in the phrases “shop worker” and “betting worker”) means an individual who has entered into or works under (or, where the employment has ceased, worked under)—
- (a) a contract of employment, or
  - (b) any other contract, whether express or implied and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual;
- and any reference to a worker’s contract shall be construed accordingly.

*[The section 230(3) definition of “worker” is applicable to Reg 2(1) Working Time Regulations and to Reg 2 of the Agency Workers Regulations 2010 – except adding the words “who is not an agency worker” to the preamble after “individual”.]*

- (4) In this Act “employer”, in relation to an employee or a worker, means the person by whom the employee or worker is (or, where the employment has ceased, was) employed.
- (5) In this Act “employment”—
- (a) in relation to an employee, means (except for the purposes of section 171) employment under a contract of employment, and
  - (b) in relation to a worker, means employment under his contract;
- and “employed” shall be construed accordingly.

#### Section 231 Associated employers

For the purposes of this Act any two employers shall be treated as associated if—

- (a) one is a company of which the other (directly or indirectly) has control, or
- (b) both are companies of which a third person (directly or indirectly) has control;

and “associated employer” shall be construed accordingly.

## **Income Tax (Earnings and Pensions) Act 2003**

### **Chapter 7 Application of provisions to agency workers**

#### **Section 44 Treatment of workers supplied by agencies**

- (1) This section applies if—
  - (a) an individual (“the worker”) personally provides services (which are not excluded services) to another person (“the client”),
  - (b) there is a contract between—
    - (i) the client or a person connected with the client, and
    - (ii) a person other than the worker, the client or a person connected with the client (“the agency”), and
  - (c) under or in consequence of that contract—
    - (i) the services are provided, or
    - (ii) the client or any person connected with the client pays, or otherwise provides consideration, for the services.
- (2) But this section does not apply if—
  - (a) it is shown that the manner in which the worker provides the services is not subject to (or to the right of) supervision, direction or control by any person, or
  - (b) remuneration receivable by the worker in consequence of providing the services constitutes employment income of the worker apart from this Chapter.
- (3) If this section applies—
  - (a) the worker is to be treated for income tax purposes as holding an employment with the agency, the duties of which consist of the services the worker provides to the client, and
  - (b) all remuneration receivable by the worker (from any person) in consequence of providing the services is to be treated for income tax purposes as earnings from that employment, but this is subject to subsections (4) to (6).
- (4) Subsection (5) applies if (whether before or after the worker begins to provide the services)—
  - (a) the client provides the agency with a fraudulent document which is intended to constitute evidence that, by virtue of subsection (2)(a), this section does not or will not apply, or
  - (b) a relevant person provides the agency with a fraudulent document which is intended to constitute evidence that, by virtue of subsection (2)(b), this section does not or will not apply.



- (5) In relation to services the worker provides to the client after the fraudulent document is provided—
- (a) subsection (3) does not apply,
  - (b) the worker is to be treated for income tax purposes as holding an employment with the client or (as the case may be) with the relevant person, the duties of which consist of the services, and
  - (c) all remuneration receivable by the worker (from any person) in consequence of providing the services is to be treated for income tax purposes as earnings from that employment.
- (6) In subsections (4) and (5) “relevant person” means a person, other than the client, the worker or a person connected with the client or with the agency, who—
- (a) is resident, or has a place of business, in the United Kingdom, and
  - (b) is party to a contract with the agency or a person connected with the agency, under or in consequence of which—
    - (i) the services are provided, or
    - (ii) the agency, or a person connected with the agency, makes payments in.

## **Section 45 Arrangements with agencies**

If—

- (a) an individual (“the worker”), with a view to personally providing services (which are not excluded services) to another person (“the client”), enters into arrangements with a third person, and
- (b) the arrangements are such that the services (if and when they are provided) will be treated for income tax purposes under section 44 as duties of an employment held by the worker,

any remuneration receivable under or in consequence of the arrangements is to be treated for income tax purposes as earnings from that employment.

## **Section 46 Cases involving unincorporated bodies etc.**

- (1) Section 44 also applies—
- (a) if the worker personally provides the services in question as a partner in a firm or a member of an unincorporated body;
  - (b) if the agency in question is an unincorporated body of which the worker is a member.
- (2) In a case within subsection (1)(a), remuneration receivable in consequence of the worker providing the services is to be treated for income tax purposes as income of the worker and not as income of the firm or body.

## **Section 46A Anti-avoidance**

- (1) This section applies if—

- (a) an individual ("W") personally provides services (which are not excluded services) to another person ("C"),
  - (b) a third person ("A") enters into arrangements the main purpose, or one of the main purposes, of which is to secure that the services are not treated for income tax purposes under section 44 as duties of an employment held by W with A, and
  - (c) but for this section, section 44 would not apply in relation to the services.
- (2) In subsection (1)(b) "arrangements" includes any scheme, transaction or series of transactions, agreement or understanding, whether or not legally enforceable, and any associated operations.
- (3) Subject to subsection (2) of section 44, that section applies in relation to the services.
- (4) For the purposes of subsection (3)—
- (a) W is to be treated as being the worker,
  - (b) C is to be treated as being the client,
  - (c) A is to be treated as being the agency, and
  - (d) section 44 has effect as if subsections (4) to (6) of that section were omitted.

## Section 47 Interpretation of this Chapter

- (1) In this Chapter "agency contract" means a contract made between the worker and the agency under the terms of which the worker is obliged to personally provide services to the client.
- (2) In this Chapter "excluded services" means—
- (a) services as an actor, singer, musician or other entertainer or as a fashion, photographic or artist's model, or
  - (b) services provided wholly—
    - (i) in the worker's own home, or
    - (ii) at other premises which are neither controlled or managed by the client nor prescribed by the nature of the services.
- (3) For the purposes of this Chapter "remuneration"—
- (a) does not include anything that would not have constituted employment income of the worker if it had been receivable in connection with an employment apart from this Chapter, but
  - (b) subject to paragraph (a), includes every form of payment, gratuity, profit and benefit.

## Pensions Act 2008

### Section 88 "Employer", "worker" and related expressions

- (1) This section applies for the purposes of this Part.
- (2) "Contract of employment" means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing.
- (3) "Worker" means an individual who has entered into or works under—
  - (a) a contract of employment, or
  - (b) any other contract by which the individual undertakes to do work or perform services personally for another party to the contract.
- (4) But a contract is not within subsection (3)(b) if the status of the other party is by virtue of the contract that of a client or customer of a profession or business undertaking carried on by the individual concerned.
- (5) For the purposes of subsection (3)(b), it does not matter whether the contract is express or implied or (if it is express) whether it is oral or in writing.
- (6) Any reference to a worker's contract is to be read in accordance with subsections (3) to (5).
- (7) "Employer", in relation to a worker, means the person by whom the worker is employed (subject to sections 37(5) and 38(6)).
- (8) "Employment" in relation to a worker, means employment under the worker's contract, and related expressions are to be read accordingly.

### Section 89 Agency workers

- (1) This section applies to an individual ("the agency worker")—
  - (a) who is supplied by a person ("the agent") to do work for another person ("the principal") under a contract or other arrangements made between the agent and the principal,
  - (b) who is not, as respects that work, a worker, because of the absence of a worker's contract between the individual and the agent or the principal, and
  - (c) who is not a party to a contract under which the agency worker undertakes to do the work for another party to the contract whose status is, by virtue of the contract, that of a client or customer of a profession or business undertaking carried on by the individual.
- (2) Where this section applies, the other provisions of this Part have effect—
  - (a) as if there were a worker's contract for the doing of the work by the agency worker, made between the agency worker and the relevant person under subsection (3), and
  - (b) as if that person were the agency worker's employer.
- (3) The relevant person is—

- (a) whichever of the agent and the principal is responsible for paying the agency worker in respect of the work, or
- (b) if neither the agent nor the principal is responsible for doing so, whichever of them pays the agency worker in respect of the work.

## **National Minimum Wage Act 1998**

### **Section 34 Agency workers who are not otherwise “workers”**

#### **[Section 34 applicable to Reg 36 Working Time Regulations]**

- (1) This section applies in any case where an individual (“the agency worker”)—
  - (a) is supplied by a person (“the agent”) to do work for another (“the principal”) under a contract or other arrangements made between the agent and the principal; but
  - (b) is not, as respects that work, a worker, because of the absence of a worker’s contract between the individual and the agent or the principal; and
  - (c) is not a party to a contract under which he undertakes to do the work for another party to the contract whose status is, by virtue of the contract, that of a client or customer of any profession or business undertaking carried on by the individual.
- (2) In a case where this section applies, the other provisions of this Act shall have effect as if there were a worker’s contract for the doing of the work by the agency worker made between the agency worker and—
  - (a) whichever of the agent and the principal is responsible for paying the agency worker in respect of the work; or
  - (b) if neither the agent nor the principal is so responsible, whichever of them pays the agency worker in respect of the work.

### **Section 35 Home workers who are not otherwise “workers”**

- (1) In determining for the purposes of this Act whether a home worker is or is not a worker, section 54(3)(b) below shall have effect as if for the word “personally” there were substituted “(whether personally or otherwise)”.
- (2) In this section “home worker” means an individual who contracts with a person, for the purposes of that person’s business, for the execution of work to be done in a place not under the control or management of that person.

### **Section 41 Power to apply Act to individuals who are not otherwise “workers”**

The Secretary of State may by regulations make provision for this Act to apply, with or without modifications, as if—

- (a) any individual of a prescribed description who would not otherwise be a worker for the purposes of this Act were a worker for those purposes;
- (b) there were in the case of any such individual a worker’s contract of a prescribed description under which the individual works; and

- (c) a person of a prescribed description were the employer under that contract.

## Section 54 Meaning of “worker”, “employee” etc.

(1) In this Act “employee” means an individual who has entered into or works under (or, where the employment has ceased, worked under) a contract of employment.

(2) In this Act “contract of employment” means a contract of service or apprenticeship, whether express or implied, and (if it is express) whether oral or in writing.

(3) In this Act “worker” (except in the phrases “agency worker” and “home worker”) means an individual who has entered into or works under (or, where the employment has ceased, worked under)—

(a) a contract of employment; or

(b) any other contract, whether express or implied and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual;

and any reference to a worker’s contract shall be construed accordingly.

(4) In this Act “employer”, in relation to an employee or a worker, means the person by whom the employee or worker is (or, where the employment has ceased, was) employed.

(5) In this Act “employment”—

(a) in relation to an employee, means employment under a contract of employment; and

(b) in relation to a worker, means employment under his contract;

and “employed” shall be construed accordingly.

## Limited Liability Partnerships

### Section 863 of Income Tax (Trading and Other Income) Act 2005

The new LLP rules introduced in Finance Act 2014 set out three conditions:

#### *Condition A*

This is satisfied if there are “arrangements” in place as a result of which M is to perform services for the LLP as a member and it is reasonable to expect that M is to be rewarded for those services by a “disguised salary”.

The legislation says that an amount is a disguised salary<sup>209</sup> “if it –

(a) is fixed,

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<sup>209</sup> Section 863B ITTOIA 2005

- (b) if it is variable, is varied without reference to the overall amount of the profits or losses of the LLP, or
- (c) is not, in practice, affected by the overall amount of those profits or losses.”

At the time that the condition is considered, it is reasonable to expect that at least 80% of the total amount payable by the LLP in respect of M’s performance, during the relevant period, of services for the LLP in M’s capacity as a member will be disguised salary.

#### *Condition B*

This is that the mutual rights and duties of the members of the LLP, and of the partnership and its members, do not give M “significant influence” over the affairs of the partnership.

#### *Condition C*

This is that, at the time the condition is being considered, M’s contribution to the LLP is less than 25% of the disguised salary which it is reasonable to expect will be payable by the LLP in respect of M’s performance, during the relevant tax year, of services for the LLP in M’s capacity as a member.

## **Employment status case law:**

HMRC Employment status manual, Appendix 1: Case law: table of cases (in alphabetical order)

ESM No.	Case	Citation
<a href="#">ESM7060</a>	Airfix Footwear Ltd v Cope	[1978] ICR 1210 EAT
<a href="#">ESM7150</a>	Andrews v King	[1991] 64 TC 332
<a href="#">ESM7310</a>	Autoclenz Ltd and Belcher & Ors	[2009] EWCA Civ 1046
<a href="#">ESM7170</a>	Barnett v Brabyn	[1996] 69 TC 133
<a href="#">ESM7200</a>	Carmichael & Another v National Power plc	[1999] 1 WLR 2042
<a href="#">ESM7190</a>	Clark v Oxfordshire Health Authority	[1998] IRLR 125
<a href="#">ESM7020</a>	Davies v Braithwaite	[1933] 18 TC 198
<a href="#">ESM7290</a>	Dragonfly Consultancy Ltd v HMRC	[2008] EWHC 2113 (Ch)
<a href="#">ESM7080</a>	Edwards v Clinch	[1981] 56TC367
<a href="#">ESM7210</a>	Express & Echo Publications Ltd v Ernest Tanton	[1999] IRLR367
<a href="#">ESM7055</a>	Fall v Hitchen	[1973] 49 TC 435
<a href="#">ESM7280</a>	Future Online Ltd v Foulds	[2004] 76 TC 590
<a href="#">ESM7160</a>	Hall v Lorimer	[1994] 66TC349
<a href="#">ESM7165</a>	Lane v The Shire Roofing Company (Oxford) Ltd	[1995] TLR104

<a href="#">ESM7300</a>	Larkstar Ltd v HMRC	[2008] EWHC 3284 (Ch)
<a href="#">ESM7140</a>	Lee Ting Sang v Chung Chi-Keung	[1990] 2AC374
<a href="#">ESM7220</a>	MacFarlane & Skivington v Glasgow City Council	[2000] EAT/1277/99
<a href="#">ESM7040</a>	Market Investigations Ltd v Minister of Social Security	[1969] 2QB173
<a href="#">ESM7070</a>	Massey v Crown Life Insurance Company	[1978] 1WLR676
<a href="#">ESM7240</a>	Montgomery v Johnson Underwood Ltd	[2001] (unreported)
<a href="#">ESM7025</a>	Morren v Swinton and Pendlebury Council	[1965] 1WLR576
<a href="#">ESM7090</a>	Narich Pty. Limited v The Commissioner of Pay-roll Tax	[1984] ICR286
<a href="#">ESM7110</a>	Nethermere (St Neots) Ltd v Gardiner and Taverna	[1984] IRLR240
<a href="#">ESM7100</a>	O'Kelly and Others v Trusthouse Forte plc	[1984] 1QB90
<a href="#">ESM7030</a>	Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance - facts	[1967] 2QB497
<a href="#">ESM7180</a>	Secretary of State for Employment v McMeechan	[1997] IRLR353
<a href="#">ESM7120</a>	Sidey v Phillips	[1986] 59TC458
<a href="#">ESM7230</a>	St John's College School, Cambridge v Secretary of State for Social Security	12 June [2000] (unreported)
<a href="#">ESM7260</a>	Synaptex Ltd v Young	[2003] 75TC51
<a href="#">ESM7270</a>	Usetech Ltd v Young	[2004] 76TC811
<a href="#">ESM7250</a>	Todd v Adams	[2002] 18 April (unreported)
<a href="#">ESM7130</a>	Walls v Sinnett	[1986] 60TC150

There are 32 cases of which 27 are non-IR35:

11 are for employment rights (5 employed/6 self-employed) and

11 are concerning tax (6 employed/5 self-employed),

1 concerns an office-holder (held not to be an office-holder),

2 are personal injury cases (both held to be employed),

1 on superannuation (employed) and

1 on the Merchant Shipping Act (held to be self-employed).

# Categories of working persons

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This Annex lists categories of individuals or groups who are particularly affected by employment status:

## Personal service companies

**E.1** Personal service companies are people technically employed by their own limited company for tax purposes usually on low salary, high dividends – unless a “deemed employee” under IR35 – and with no equivalent employment rights.

### Legislation affecting personal service companies

- IR35 – Chapter 8 of Part 2 of ITEPA 2003<sup>210</sup> and in the Social Security Contributions (Intermediaries) Regulations 2000, SI 2000/727
- Managed Service Companies - Chapter 9 of Part 2 and section 688A, Part 11 ITEPA 2003
- Agency Workers Regulations 2010 – in or out of scope established by Employment Status Test (no limited company opt-out)
- Conduct of Employment Agencies and Employment Businesses Regulations 2003 (section 32 – contains an opt-out for limited companies)
- Onshore intermediaries – section 44(2) ITEPA 2003, no direct opt-out, but thought not to include personal service companies although it is still unclear whether PSCs will be included in the reporting regulations
- Umbrella companies – under consultation which closed 10 February 2015: <https://www.gov.uk/government/consultations/employment-intermediaries-temporary-workers-relief-for-travel-and-subsistence-expenses>

### Office holder (personal service company)

**E.2** An extension of IR35 to those who provide their services personally as an ‘office holder’. The majority provide their services through a personal service company, IR35 was extended to cover this in 2013. This change applies when a worker’s personal services are supplied via an intermediary to perform the duties of an office, including when:

- A worker is personally appointed to perform the duties of an office
- An intermediary is appointed as a corporate office-holder, provides the worker to perform the duties of that office and the worker’s personal services are required
- A worker is engaged both as an office-holder and to perform other duties in circumstances when they would be regarded as an employee if they were engaged directly by the client. For example, a director also engaged as a Chief Executive Officer who has some duties arising from their office but in addition has managerial

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<sup>210</sup> Income Tax (Earnings and Pensions) Act 2003



duties whereby they are mainly responsible for the client company's day-to-day activities.

- A worker has earnings from an employment that have already been subject to PAYE/NICs by a client but they are also engaged by that client as an office-holder. (For example, the salaried Chief Financial Officer of a charity who is also engaged as a director of the charity).

## Office holders - section 5 ITEPA 2003

**E.3** Under section 5 ITEPA 2003, the provisions of the employment income Parts of ITEPA that are expressed to apply to employments apply equally to offices, unless otherwise indicated. Section 2(1) and section 7 Social Security Contributions and Benefits Act 1992 apply for NICs.

**E.4** Section 5(3) defines "office" as including "any position which has an existence independent of the person who holds it and may be filled by successive holders." This is based on the case law definition of "office" as a "...*permanent, substantive position which had an existence independent from the person who filled it, which went on and was filled in succession by successive holders.*" [Rowlatt J in *Great Western Railway Company v Bater* 8TC231.]

## Traditional partnership

**E.5** The Partnership Act 1890 defines partnership as "...the relation which subsists between persons carrying on a business in common with a view of profit." The partnership is not a legal entity in itself (apart from in Scotland) and the partners are self-employed for tax purposes.

## Limited liability partnerships (LLPs)

**E.6** Legislation on LLPs is in section 863 Income Tax (Trading and Other Income) Act 2005 (ITTOIA) – see Annex D

**E.7** The tax rules for LLPs provide that any individual LLP member is treated as self-employed for tax purposes and subject to income tax and Class 4 NICs on the partnership profit share. The rule was intended to treat LLP members in the same way as partners in traditional partnerships.

**E.8** The new "salaried members" rules were brought in in Finance Act 2014 to make the tax rules fairer across partnership types. This ensures that LLP members who are, in effect, providing services on terms similar to employment are treated as "employees" for tax purposes.

**E.9** In the recent case of *Clyde & Co v Bates van Winkelhof* [2014] UKSC 32, the employment status of a partner, albeit one under the LLP legislation, was challenged. The partner was held to be a limb b worker for the purposes of whistle-blowing and sex discrimination legislation.

## Employee shareholders

**E.10** Legislation is in section 205A of the Employment Rights Act 1996 (ERA).

**E.11** An employee shareholder is a new employment status, available from 1 September 2013. Employee shareholders have different employment rights to employees, and are awarded at least £2,000 worth of shares in their employer or a parent company. There is no requirement for businesses wishing to offer an employee shareholder contract to obtain HMRC approval or agreement.

**E.12** There are special tax rules for shares received under an employee shareholder agreement, which applied from the launch of the new employment status on 1 September 2013.

**E.13** Although HMRC have indicated that the employee shareholder is a new 'employment status', it does not involve distinguishing between employed or self-employed under tax law, but it creates a different class of employee under employment law. HMRC guidance is available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/365387/guidance-it-ess.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/365387/guidance-it-ess.pdf)

## **Sole trader – person in business**

**E.14** A sole trader is an individual carrying on business as an unincorporated entity. They may or may not employ any or many others, and may be a skilled or semi-skilled business. They should be registered self-employed with HMRC under a unique taxpayer reference although there is a hidden economy of those that don't register or pay tax.

## **Registered self-employed – sole trader**

**E.15** There is no statutory definition of a self-employed individual, or a so called 'sole trader', so it is basically an individual who provides their services as either themselves or 'trading as', and not as an incorporated entity.

**E.16** A sole trader needs to register by 5 October following the end of the tax year that a tax return is sent in for. A penalty may have to be paid for late registration.

## **Onshore intermediaries – false self-employment**

**E.17** This legislation came into force on 6 April 2014 and it amended section 44 ITEPA so if a worker is supplied through an agency and is subject to direction, supervision or control by the end client, they will be treated as an employee for tax purposes and the agency will have to deduct income tax and NICs and report this to HMRC.

## **Agency workers regulations 2010**

**E.18** Whether these apply depends on whether the individual is in business on their own account.

## **Construction workers**

**E.19** HMRC's Construction Industry Scheme sets out the rules for how payments to sub-contractors who work in the construction industry must be made by contractors. HMRC recently carried out a consultation on improving the Construction Industry Scheme, which closed on 22 Sept 2014.

**E.20** HMRC Guidance for sub-contractors and contractors is published here: [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/366129/cis340.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/366129/cis340.pdf)

## **Limb 'b' workers**

**E.21** The main legislation is in section 230(3)(b) Employment Rights Act 1996 (and other pieces of legislation shown in Annex D).

**E.22** The reclassification from self-employed to worker may be challenged by the 'worker' through the employment tribunal. This can be for a claim for day one rights (harassment, discrimination, etc.) or for other rights such as holiday entitlement or national minimum wage. 'Worker' status is not recognised in tax law and it is called limb 'b' because it is subsection (b) of, for example, section 230 (3)(b) Employment Rights Act 1996

**E.23** A worker is entitled to basic employment rights including:

- national minimum wage;
- unlawful deduction of wages;
- discrimination legislation;
- whistle-blowing; but
- not entitled to unfair dismissal rights

## Home workers

**E.24** Home workers come under section 35(2) of the National Minimum Wage Act 1998.

**E.25** “Home worker” means an individual who contracts with a person, for the purposes of that person’s business, for the execution of work to be done in a place not under the control or management of that person.

**E.26** Home workers are not specifically mentioned by the Working Time regulations 1998, and are excluded from the agency worker rules by section 47 ITEPA 2003 if the services are provided wholly in the worker’s own home.

## Agency workers

**E.27** Individuals who work through employment agencies or businesses, as defined below, may provide their services through a personal service company, as a self-employed individual, as a limb b worker or as an employed individual. The status of the ‘agency worker’ in the non-technical sense is defined by employment status case law. Although, as already mentioned, a personal service company will be subject to IR35 and other legislation, as will those who are self-employed.

**E.28** There is also a statutory ‘agency worker’ that will have specific tax treatment and employment rights, specifically under the agency worker regulations 2010.

### Legislation affecting agency workers:

- Working Time regulations - Part V – special classes of person  
section 36: agency workers who are not otherwise “workers”
- National Minimum Wage Act 1998  
section 34: agency workers who are not otherwise “workers”

**E.29** Under the agency workers regulations, employment status case law is used to establish whether an agency worker is entitled to equal pay after 12 weeks, and section 44 ITEPA also applies. There is an exemption for those “in business on their own account”.

## Employment agency

**E.30** Employment agencies and employment businesses are defined by section 13 of the Employment Agencies Act 1973:

13(2) For the purposes of this Act “employment agency” means the business (whether or not carried on with a view to profit and whether or not carried on in conjunction with any other business) of providing services (whether by the provision of information or

otherwise) for the purpose of finding workers employment with employers or of supplying employers with workers for employment by them.

13(3) For the purposes of this Act “employment business” means the business (whether or not carried on with a view to profit and whether or not carried on in conjunction with any other business) of supplying persons in the employment of the person carrying on the business, to act for, and under the control of, other persons in any capacity.

**E.31** By definition, employment businesses supply temporary workers to end user clients to act for and under the control of another person. Employment agencies introduce candidates to clients who in turn engage the candidate directly. Employment businesses are often generically referred to as agencies. Chapter 7 of ITEPA 2003 refers to ‘agencies’ in reference to the treatment of agency workers when in fact the activities described are those of an employment business.

**E.32** For ease and in line with the ITEPA reference we refer to agency/agencies in this report in relation to the supply of agency workers.

## Zero hours workers – typically unskilled and semi-skilled workers

**E.33** The term 'zero hours' is not defined in legislation, but it is generally a contract that has no mutual obligations and, as such, is thought not to be a contract of employment, although in some circumstances it can be. The zero hours contract is thought to be “any other contract” which would give the individual the status of a limb b worker and a limb b worker may be classed as self-employed for tax purposes.

**E.34** The Department for Business, Innovation and Skills has launched a review to improve the clarity and status of the British workforce and this includes the employment status of the “worker” and specifically zero hours contracts. The government has recently banned exclusivity clauses in zero hours contracts.

## Umbrella worker

**E.35** Any type of worker may be employed but may also be a limb b worker with expenses claims for travel. This area has recently been subject to an HMRC consultation: <https://www.gov.uk/government/consultations/employment-intermediaries-temporary-workers-relief-for-travel-and-subsistence-expenses> )

## Interns

**E.36** There is no legal definition for “interns” and interns usually aren’t paid by the engager and some do not receive expenses either. It is arguable that they may, however, be “limb b workers” who should receive the national minimum wage and other basic employment rights.

## Volunteers

**E.37** The Police Act 1997 (Criminal Records) Regulations 2002 defines a “volunteer” as “...a person engaged in an activity which involves spending time, unpaid (except for travel and other approved out-of-pocket expenses), doing something which aims to benefit some third party other than or in addition to a close relative.”

**E.38** The **Compact Code of Good Practice on Volunteering** defines volunteering as – “an activity that involves spending time, unpaid, doing something that aims to benefit the environment or individuals or groups other than (or in addition to) close relatives.”

**E.39** The status of a volunteer can be challenged by HMRC on the basis that the volunteer is an “office-holder”. Also status issues can arise based on unreceipted expenses being ‘round sum payments’.

**E.40** Volunteers are not entitled to the national minimum wage under section 44 (b) National Minimum Wage Act 1996 if the work is done for a charity, a voluntary organisation, an associated fundraising body or a statutory body.

**E.41** It is possible that payments such as honoraria could count as taxable employment income and, it then follows that, any travel and subsistence expenses would not be allowable if the worker is travelling from home.

**E.42** In practice, there are various different types of volunteers not just for charitable causes but for example, amateur sportsmen and women, volunteers in membership organisations, unions and sports clubs.

**E.43** The OTS understands that HMRC is to clarify its guidance on volunteers.

# List of particular occupations in HMRC guidance

## F

List of particular occupations with specific guidance in HMRC's Employment Status Manual

- Agricultural workers - harvest workers
- Agricultural workers - contract milkers
- Barristers' clerks
- Careworkers
- Cleaners
- Computer staff supplied by agencies
- Consultants and other professionals
- Demonstrators and merchandisers
- Dentists
- Dental hygienists and therapists
- Directors
- Divers and diving supervisors
- Doctors
- Doctors - agency doctors
- Doctors - locums
- Election agents
- Electoral Registration Officers and their staffs - England and Wales
- Electoral Registration Officers and their staffs - Scotland and Northern Ireland
- Entertainment industry
  - Film and Video Workers
    - Front of camera workers
    - Behind camera workers
  - Television and Radio Workers
    - Front of camera workers
    - Behind camera workers
  - Theatrical Workers

- Reserved Schedule D position
  - Schedule E/employment income deduction for fees paid to agents
  - Stage management
  - Other non-performing workers
  - Designers, directors, choreographers
- Musicians
  - Orchestral players
- Examiners
- Family employment - by spouse
- Family employment - other than by spouse
- Fellowships
- Guardians Ad Litem and Reporting Officers
- Journalists
- Journalists - casual journalists
- Local Veterinary Inspectors (LVIs)
- Lorry drivers - general
- Lorry drivers - leasing agreements
- Lorry drivers - short-term engagements
- Market researchers
- Milk roundsmen - general
- Milk roundsmen - franchise agreements
- Nominee directors - ESC A37
- Nursing staff who are employees
- Nursing staff engaged through agencies
- Parish and Community Council Clerks
- Pharmacists (locum)
- Recorders, Circuit Judges, Deputy High Court Judges and Deputy Circuit Judges
- Returning Officers etc
- School Inspectors
- Subcontractors in the construction industry
- Subcontractors in the construction industry - status - long-term engagements
- Subcontractors in the construction industry - status - short-term engagements

- Sub-postmasters / Sub-postmistresses
- Teachers, lecturers and tutors - full-time lecturers
- Teachers, lecturers and tutors - part-time and visiting/occasional lecturers
- Trustees under a will, settlement etc.
- Voluntary organisations - workers and employees





# List of occupations represented at OTS meetings

## G

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- Academics
- Bailiffs
- BBC workers
- Construction industry
- Designers
- Doctors – GPs and locums
- Drinks industry – promotional individuals
- Equity workers (e.g. actors)
- Film technicians
- Forestry workers
- Infrastructure, automotive, IT
- Managed public services
- Ministers of religion
- Nannies
- Nightclub dancers
- Nuclear specialists
- Scaffolders
- Shepherds
- Teachers and assistants
- Trade union volunteers
- Translators
- Train operators

# H Tables of tax/NICs differences

**H.1** Tables H.1 and H.2 show the differences in tax and NICs for two levels of output - £400 and £1,000 per week – across employment, self-employment, and close company bonus and dividend.

**Table H.1: Total tax and NICs by legal form 2014/15 (assumes output £400 per week)**

	Employment	Self-employment	Close company bonus	Close company dividend
<b>Value of output</b>	400.00	400.00	400.00	400.00
<b>Employer NICs</b>	34.09	0	29.95	0
<b>Gross income</b>	400.00	400.00	370.05	320.00
<b>Employee NICs</b>	29.64	0	26.05	0
<b>Self-employed NICs</b>	0	24.98	0	0
<b>Taxable profits</b>	0	0	0	400.00
<b>Corporation tax</b>	0	0	0	80.00
<b>Taxable income</b>	207.69	207.69	177.74	320.00
<b>Income tax</b>	41.53	41.53	35.55	0
<b>Cost to engager</b>	434.09	400.00	400.00	400.00
<b>Net income</b>	<b>328.83</b>	<b>333.49</b>	<b>308.45</b>	<b>320.00</b>

**Table H.2: Total tax and NICs by legal form 2014/15 (assumes output £1,000 per week)**

	Employment	Self-employment	Close company bonus	Close company dividend
<b>Value of output</b>	1,000.00	1,000.00	1,000.00	1,000.00
<b>Employer NICs</b>	116.89	0	102.95	0
<b>Gross income</b>	1,000	1,000.00	897.05	800.00
<b>Employee NICs</b>	82.14	0	80.08	0
<b>Self-employed NICs</b>	0	65.34	0	0
<b>Taxable profits</b>	0	0	0	1,000.00
<b>Corporation tax</b>	0	0	0	200.00
<b>Taxable income</b>	807.69	807.69	704.74	800.00
<b>Income tax</b>	200.51	200.51	159.33	18.85
<b>Cost to engager</b>	1,116.89	1,000.00	1,000.00	1000.00
<b>Net income</b>	<b>717.35</b>	<b>734.15</b>	<b>657.64</b>	<b>781.15</b>

**H.2** The examples use contracted-in class 1 NICs rates of 13.8% for employers and 12% for employees and an earnings threshold of £153 per week. For employee contributions above the upper earnings limit of £805 the rate of 2% applies. For self-employed NICs, the examples use the class 4 contribution rates of 9%; and 2% above the upper profits limit, plus class 2

contributions at the flat rate of £2.75 per week. They also assume a personal allowance of £10,000 per year, the basic rate of income tax of 20% up to taxable income £31,866 (10% on grossed dividends with 10% tax credit), the higher rate of income tax 40% (32.5% on grossed dividends with 10% tax credit); and the small companies' rate of corporation tax of 20%. The individual is assumed to have no other sources of income.

**H.3** A £2,000 employment allowance is deducted from employers' (secondary) class 1 NIC, until exhausted. The impact on the above comparisons will depend upon the number of employees earning in excess of the lower earnings limit, and is not reflected in these figures. It is worth noting that in a single employee/director case, at a salary level of £400 per week, the employment allowance would leave no secondary class 1 NICs payable, the cost to the engager would be £400 and the net income would be £328.83.

**H.4** At a salary level of £1,000 per week, in a single employee/director case, the employment allowance would have an average impact of reducing employers' (secondary) class 1 NICs by £38.46 per week. This will reduce the cost to engager for the employment column to £1,078.43 (net income remains £717.35), while for the close company bonus column, the cost to the engager remains £1,000 but the net income increases from £657.64 to £679.94.

**Table H.3: Benefits available per class of contribution**

Benefits	Class 1	Class 2	Class 3
<b>Pensions</b>			
Basic State Pension	✓	✓	✓
State Earnings Related Pension (SERPS)	✓		
State Second Pension (06/04/02)	✓		
Graduated Pension (1961 - 1975)	✓		
<i>Incapacity/Disability</i>			
Incapacity Benefit (replaced Invalidity Benefit from April 1995)	✓	✓	
Earnings-related	✓		
<i>Bereavement</i>			
Bereavement Payment (replaced Widow's Payment from April 2001 <sup>211</sup> )	✓	✓	✓
Bereavement Allowance (replaced Widow's Pension from April 2001 <sup>212</sup> )	✓	✓	✓
Widowed Parents Allowance (replaces Widowed Mother's Allowance from April 2001 <sup>213</sup> )	✓	✓	✓
Widowed Parents Allowance (earnings-related)	✓		
<i>Unemployment</i>			
Job-Seekers Allowance (contribution based)	✓		
Income Support	✓	✓	
<b>Statutory Payments</b>			
Statutory Sick Pay	✓		
Statutory Maternity Pay	✓		
Statutory Paternity Pay	✓		
Statutory Adoption Pay	✓		

<sup>211</sup> Section 36A Social Security Contributions and Benefits Act 1992

<sup>212</sup> Section 39B Social Security Contributions and Benefits Act 1992

<sup>213</sup> Section 39A Social Security Contributions and Benefits Act 1992

<b>Maternity</b>			
Maternity Allowance	✓	✓	
Maternity Benefit	✓	✓	

**H.5** Table H.3 is extracted from a report for the Federation of Small Businesses "Should Class 4 National Insurance Contributions be Abolished?" [2005] Elicitor Ltd

**H.6** Class 1A contributions payable by the employer and class 4 contributions by the self-employed provide no benefit entitlement. Class 3A voluntary contributions will top up the basic state pension where there is a contributory shortfall.

# International case studies

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## Australia

**I.1** There are three primary categories of worker in Australia<sup>214</sup>: employee, independent contractor and agency worker. Australia has a lot of similarity to the UK in determining employment status. The factors for determining status rest with the business engaging the individual to undertake the work. Wrongly categorising an individual as a contractor can result in the business facing penalties and charges. There are differing tax obligations whether you are employed or a contractor.

**I.2** An individual who registers as a business and receives an Australian Business Number should not automatically be treated as a contractor when undertaking work for a business. Also, just because someone has specialist skills does not mean that they are considered to be a contractor when undertaking work. The Australian courts still use common law tests to determine if an individual is an employee or a contractor. Control is seen as the most important single indicator.<sup>215</sup> The main tests are listed below:

- control over work
- integration into the organisation
- substitution
- basis of payment - fixed fee
- use of own tools and equipment and other assets
- commercial risk - rectifying the problem at the individual's own expense.

**I.3** The Australian Taxation Office (ATO) has two online employee/contractor decision tools for use to determine the status of an individual:

- a tool for the building and construction industry
- a general employee/contractor decision tool.

**I.4** The OTS used the Australian decision indicator tool for a number of examples and found it to be more user-friendly than the current version developed by HMRC. The main differences are around the general layout of screens, the user-friendly nature of how questions have been worded and the help option for each question which holds a significant amount of information, including examples to support a correct decision being made. Provided the responses accurately reflect the working arrangement the result provided by the decision tool can be relied upon. The ATO have said they will not charge a penalty that might otherwise apply. To help businesses comply, the ATO use a combination of education and compliance measures.

**I.5 Employees** work specifically for an employer in a personal capacity whereas **independent contractors** provide a particular function or undertake a specific role and can either be appointed personally or through their own company.

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<sup>214</sup> <http://uk.practicallaw.com/3-503-3758>

<sup>215</sup> ATO Taxation ruling TR 2005/16

**1.6** The work undertaken by independent contractors is considered to be “personal services income” when the income exceeds 50% of the contract value which denotes the “skills, knowledge, expertise or efforts of the individuals who performed the services” is provided.<sup>216</sup> This does not apply if materials and equipment equate to more than 50% of the contract value.

**1.7** For some time, independent contractors have been subject to specific tests and performance measures set down by the Australian Taxation Office in order to identify the level of personal service income. More stringent changes to the rules are currently being mooted and the body representing Australian independent contractors is campaigning against these.

**1.8** The range of disciplines covering independent contractors is significant and includes areas such as information technology, marketing freelancers, construction workers and so on and there are three main steps used to determine whether the “personal services income” rules apply:

- **Results** – if yes is answered to the following questions for 75% of the income or more:
  - payment is received after the work is completed (milestone payments can be included)
  - the contractor’s business is required to provide tools and equipment
  - the contractor is required to correct defects at their own cost.
- **80% rule** – if 80% of a contractor’s business in a financial year comes from a single client a personal services business determination must be completed by the tax office. This 80/20 rule comes from the Alienation of Personal Services Income Act 2000 and is designed to ensure that sole trader or company director organisations are taxed in the same way as Pay as You Go employees. This relates to “personal services income”.<sup>217</sup> This is not, however, something a business would take into consideration when determining employment status as the rule is designed to support how a contractor reports their income in their tax return and if they can claim certain business deductions.
- **Others** – further tests include:
  - Whether the business receives income from in excess of two **unrelated clients** and whether they advertise externally for new work
  - Whether **employees** complete a minimum of 20% of work
  - Whether **business premises** were used solely for the business separate from home client sites.

**1.9** If these requirements are not met then an independent contractor is deemed to have failed to comply and will be classed as employed and therefore required to pay income tax and employment insurance.

**1.10 Agency employees** provide a personal service to a company that is not their own, nor by which they are technically employed as they would normally be employed by the agency (except in circumstances where an employer attempts to hide their status and imply the worker is employed by them, thus creating a “sham” contract arrangement). Evidence of workers

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<sup>216</sup> Australian Government Social Security Act 1991

<sup>217</sup> <https://www.ato.gov.au/printfriendly.aspx?url=/business/employee-or-contractor/> and <http://contractortaxation.com/book/export/html/39>

providing the same work to two employers (dual employment) is limited and the Fair Work Act 2009 prohibits companies entering into “sham” independent contracts, despite the fact that most of the country’s employment legislation relates to employees.

## Income tax<sup>218</sup> and social security contributions

**I.11** Australia has a progressive marginal rate scale of up to 45% on **taxable income** over \$180,000. From 1 July 2014 a “temporary budget repair levy” was introduced adding an additional 2% due on any taxable income over \$180,000. Tax residents are also liable for a 2% Medicare levy (collected as income tax) which increases by an additional 1 to 1.5% if the employee does not have sufficient private cover and income exceeds the levels outlined below:

- \$90,000 for singles and \$180,000 for couples and families: 1%
- \$105,000 for singles and \$210,000 for couples and families: 1.25%
- \$140,000 for singles and \$280,000 for couples and families: 1.5%

**I.12 Superannuation** contributions from employers are required (currently 9.5% of ordinary time earnings, increasing gradually to 12% by 2019/2020, up to an indexed statutory quarterly cap). Exemptions do apply, including for foreign nationals working in the country and those not tax residents of Australia, if remuneration arrangements meet specific criteria. Seconded employees retain their home country pension scheme, usually for up to five years under reciprocal social security totalisation agreements. There is a requirement for a superannuation guarantee contribution, paid at 9.5% of “ordinary time earnings” up to a cap of \$49,430 per quarter.

**I.13 Payroll tax** has different thresholds and rates as this is imposed by states and territories independently. Employers are required to meet a payroll tax equating to a percentage of their total salary bill if it exceeds specific thresholds. Employer obligations also include registration, monthly payments, and annual returns with annual reconciliation payments.

**I.14** Common myths keep arising concerning Australian employment status, for example:

- **Having an Australian Business Number (ABN)**

Myth: If a worker has an ABN they are a contractor.

Fact: Just because a worker has an ABN does not mean that they will be a contractor for every job. A business may attempt to disguise the employment arrangements of an individual to make the work look like contracting in order to avoid obligations to Pay As You Go withholding and super obligations. To correctly determine whether a worker is an employee or contractor, the nature of the working arrangement and specific terms and conditions need to be considered.

- **Specialist skill or qualification**

Myth: Workers used for their specialist skills should be engaged as contractors.

Fact: Qualifications or skilled workers including 'blue collar' or 'white collar' makes no difference to whether a worker is an employee or contractor.

## Brazil

**I.15** In Brazil, an employer is classified as a company by articles 2 and 3 of the Labor Code as they accept the risk associated with the activity and they hire and pay the person providing the

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<sup>218</sup> <https://www.ato.gov.au/Calculators-and-tools/Simple-tax-calculator/>



service. The main criteria for being classed as an employee in Brazil is subordination, as this is considered to be a person who provides a service that is not occasional, for which they are paid and dependent upon the employer. There is also a classification for independent contractors, who receive statutory rights and protections in the same way as employees, as agreed with their employer.

**I.16** It is also possible to be classified as self-employed if the worker makes independent decisions, is only responsible for the technical elements of the work, accepts the risk of the work, can provide the service to more than one client and is not subject to subordination or disciplinary burdens. As such, self-employed workers are regulated by the Brazilian Civil Code, articles 593 and 594. If a self-employed worker provides services exclusively for an employer on an ongoing basis then an outsourcing contract can be considered to be in force.

**I.17** Contracts are usually open ended and Brazil has no statutory maximum time limit on work that may be carried out under each category. However, independent contractors who believe they are not independent and whose work includes features of an employment contract (in particular subordination) are able to claim recognition of their employment status irrespective of when they began providing the service. Nevertheless, if a service is provided to a company for a long period of time and the arrangement is exclusive this would indicate subordination and imply an employment relationship.

## Outsourcing

**I.18** Brazil does not have laws on outsourcing but it has been discussed considerably in judicial and legislative arenas. It is, however, seen to include the risk of being considered to include an employment relationship between the company and the outsourced workers due to habitualness, exclusivity and subordination. If outsourcing is considered valid, the contracting company remains liable for the service provider's employment debts if they become unable to fulfil these obligations. In some cases courts will not consider circumstances as being genuine outsourcing, for example, outsourcing the core business or outsourcing using specific workers (individually chosen) and/or workers remaining under the instructions of the contracting company.

**I.19** This is a complex area and there are bills pending voting on outsourcing in the Brazilian Congress and the Superior Labour Court recently (*Tribunal Superior do Trabalho*) made a judgement on the controversial activity of call centres and will be carrying out a public hearing on the issue.

## Colombia

**I.20** Colombia has a number of categories of employment: employment agreement, independent contractor, temporary employment agency and outsourced service. Self-employment has also increased in countries such as Colombia and government initiatives have been introduced to help facilitate this in order to aid the considerable unemployment problem.<sup>219</sup> Statutory employment rights only apply to services provided under an employment agreement.

**I.21** An **employment agreement** is deemed to be in force if a worker provides a personal service to an employer (individual or company) and as such implies subordination. Receipt of periodical payments must also be received for the service. Employment contracts must include all of the following elements:

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<sup>219</sup> <http://www.nottingham.ac.uk/gep/documents/conferences/2003/pg-conf-2003/henrard-2003.pdf>

- work must be performed by the employee personally
- the employee must remain subordinate to the employer
- there must be a salary paid to the employee for their services.

**1.22** Personnel provided to companies to assist them in their activity are engaged by **temporary employment agencies**. These “mission employees” provide the user company with services but the workers are not dependent on the company and have no element of subordination. However, subordination can be delegated by the temporary employment agency to the user company but the temporary employment agency is the real employer of the “mission employees”.

**1.23** Employment contracts are usually classified as follows:

- Indefinite – dependent upon the scope of the work and the continuation of the reasons for making the original relationship.
- Fixed-term – the term is fixed by the parties and is either less than a year or between one and three years in length.
- Time limited – timing is not specified but is based upon the length of time taken to complete the work specified in the contract.
- Occasional, accidental or transitory – usually less than one month and engaged where the work is outside the normal scope of activity provided by the company.

**1.24** It should also be noted that a new proposal of the working day is currently being studied at the National Congress.

**1.25** An **outsourcing** arrangement is in force when personal services are provided by employees working under a service agreement drawn up by the outsourcing company and the company to whom the services are being provided. The company carrying out the outsourced services is, to all intents and purposes, the sole employer and responsible for legal employment obligations with the outsourced employees. The company providing the services cannot give instructions relating to mode, time or quantity of work either to the outsourcing company or the employees.

## Income tax and social security contributions

**1.26** There is no ceiling on payroll taxes. These include taxes to the National Learning Service (SENA), Colombian Family Welfare Institute (ICBF) and Family Compensation Fund and are calculated over the ordinary salary. **Employment taxation** varies from 0% to 33% and is dependent upon whether the employee is a tax resident and the amount of salary and other earnings (including benefits) paid to the employee (excluding severance). Non-salary payments are only included if they exceed 40% of the employees' remuneration. Integral salary is taken as 70% of salary unless this exceeds 25 times the minimum legal wage.

**1.27** Social security contributions are calculated to include:

- pension contributions
- 8.5% from the employer for healthcare and 4.5% from the employee
- employer contributions of between 0.348% and 8.7% of the total amount of the employee's salary for professional risk (with a ceiling of 25 times minimum legal wage) based on risk classified at the outset.

**I.28** In 2012 a new tax “CREE” (Impuesto de Renta para la Equidad) was created that is paid annually by companies filing tax returns. The current rate is 9% over net income (minus deductions), subsequently 8%. These companies will, however, be exempted from 5% of the payroll tax to ICBG (3%) and SENA (2%) on the payroll of employees who earn less than 10 times the minimum legal monthly wage.

## France

**I.29** French workers come under four categories: employees, agency workers, independent contractors and self-employed<sup>220</sup>.

**I.30 Employees** are subject to the relevant statutory provisions as set out in the Labour Code along with collective agreements, regardless of whether their contract has a definite or indefinite term.

**I.31 Agency workers** are employed by companies to provide a service to client (using) companies that require temporary staff. Agency workers have a contract with the agency company and not the using company and have the same rights and benefits as employees. Using companies cannot take on agency workers to fill positions related to their permanent activity.

**I.32 Independent contractors** can be companies or self-employed workers who provide a commercial service or activity through a contract but are independent from their co-contractors. They usually work for more than one client as single clients can imply an employment relationship and they attract no statutory employment rights.

**I.33 Self-employment** relates to specific categories of independent workers who have specialist skills and hold state-registered diplomas and do not work under a contract of employment. Self-employment is generally in areas not considered to be commercial (for example, lawyers, accountants, medical doctors, architects) and normally for more than one client. The self-employed have no statutory employment rights but are required to comply with specific regulations applicable to their activity.

**I.34** Contracts for self-employed workers and independent contractors have no maximum duration but they can be considered as a permanent employee if there is found to be a subordinate relationship to the company.

## Income tax and social security contributions

Employers contribute 43% of gross salary and employees contribute approximately 22%. Some contributions are capped for wages up to four or eight times the social security ceiling) and employers must pay social security contributions. Employment income tax is progressive, 2013 rates being as follows:

- under €6,011: 0%
- from €6,011 to €11,990: 5.5%
- from €11,991 to €26,630: 14%
- from €26,631 to €71,396: 30%
- from €71,397 to €151,200: 41%
- over €151,200: 45%

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<sup>220</sup> <http://uk.practicallaw.com/0-503-0054?service=pensions>

## Germany

**I.35** Germany<sup>221</sup> has the following categories of worker: employees under contract in a personal dependency, non-employees (including statutory representatives, eg directors/board members) and independent contractors operating under a service contract. Employment status can be unclear in some circumstances. For example, a managing director is not an employee under employment law but is an employee under social security law as they are entitled to benefits and make contributions to social insurance.

**I.36** Statutory rights only apply to employees and company statutory representatives (who have some leeway with regard to contractual deviations). There are subsets of employees (eg trainees and executive staff) who are entitled to most statutory rights but independent contractors have no statutory rights and are not required to make social security contributions.

**I.37 Self-employed workers** can be categorised as 'employee-like' if they do not employ any workers and regularly and significantly work for only one client (in excess of 5/6 of turnover) but are not integral within the organisation, not treated as an employee and are only required to bear pension insurance cost.

**I.38** There are no minimum or maximum lengths of employment relationship although a fixed-term contract must be written and may not exceed two years if time cannot be justified by statutory grounds. Agency workers may only be temporary (likely to be 18 months maximum) and only appointed if the agency holds a labour leasing license.

**I.39** Assessments about status are made based on an evaluation including whether the following factors apply:

- the worker performs the tasks personally
- the worker is dependent on the employer for income
- the employer controls performance, hours and location
- who is responsible for social security contributions
- who accrues gratuity and pension claims
- the worker is fully integrated into the organisation.

**I.40** A contract that implies independence will be negated if it is believed that an employment relationship is in place and false declarations are dealt with severely. The employer and representatives can receive fines and criminal prosecution and be required to repay tax and social security contributions.

## Income tax and social security contributions

**I.41** Deductions are made by the employer from the gross salary. All employees pay income tax on salary at progressive rates (14% to 42%) based on income, tax class and allowances:

- single employees €8,354: tax free
- single employees €52,882: 42%
- married couples €105,764: 42%
- single employees €250,731: 45%

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<sup>221</sup> Ernst & Young

- married couples €501,462: 45%

**I.42** Employees are required to contribute to a social security system which includes pension insurance, reduction in capacity benefits, unemployment insurance, health and nursing care insurance. Employers fund accident insurance and match social security contributions, being responsible for documentation of deductions. Costs are shared between the employer and employee and are salary dependent with contributions totalling around 40%. The contribution is capped at €5,950 (in the former West Germany) and €5,000 (in the former East Germany) per month. Any employee belonging to an official church must also pay church taxes.

## Gibraltar

**I.43** Gibraltar<sup>222</sup> categorises its workers as either employees or self-employed. An **employee** is contracted to provide a service regardless of payment, the contract for which is not required to be in writing. Some employees do not fall into the legislation (seamen, casual workers, domestic workers in a private dwelling house, members of the Gibraltar Police Force, and those employed by the Ministry of Defence). **Self-employed** workers are required to pay their own taxes and social security benefits.

## Income tax and social security contributions

**I.44** Income tax is charged on gains and profits from an employment or office holding. Gibraltar has differing rates of tax (gross income and allowance based) from which resident taxpayers can choose although the Commissioner of Income Tax calculates tax based on the system which is seen to be the most beneficial to the taxpayer, irrespective of their choice. Where a taxpayer is under the gross income based system and the spouse is not, the spouse has limited availability to allowances. Those earning under GIP£10,500 are not required to pay tax.

### Gross income based tax

**I.45** Tax is applied to gross salary after deduction of allowances up to:

- GIP£1,200 for pension contributions
- GIP£6,000 for first-time home buyers
- GIP£1,000 for mortgage interest payments
- GIP£2,500 for private medical insurance
- GIP£25,000 or less
  - first GIP£10,000: 6%
  - the next GIP£7,000: 20%
  - balance: 28%
- more than GIP£25,000
  - first GIP£17,000: 16%
  - GIP£17,001 to GIP£25,000: 19%
  - from GIP£25,001 to GIP£40,000: 25%

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<sup>222</sup> <https://www.gibraltar.gov.gi/employment/>

- from GIP£40,001 to GIP£105,000: 28%
- from GIP£105,001 to GIP£500,000: 25%
- from GIP£500,001 to GIP£700,000: 18%
- from GIP£700,001 to GIP£1 million: 10%
- for amounts over GIP£1 million: 5%

### Allowances based tax

**I.46** Tax is applied to the remainder of the salary once allowances have been deducted:

- first GIP£4,000: 15%
- between GIP£4,001 and GIP£16,000: 18%
- over GIP£16,000: 40%
- high executive possessing specialist skills capped at GIP£120,000

**I.47** There is an additional tax cut based on the higher of GIP£300 or 2% of the tax payable.

**I.48** There is a minimum allowance of GIP£3,988. Men over 65 and women over 60 have an allowance of GIP£11,643 (GIP£11,175 if not claiming spouse allowance) plus a personal allowance of GIP£3,100. Other allowances can reduce taxable income including those relating to dependents, home purchases, property purchase, property improvement, pre-school, medical and life insurance.

**I.49** Employees under 60 also contribute 10% of gross income as social insurance with a minimum of GIP£5 per week and maximum GIP£25.16 per week. Self-employed people contribute 20% of gross earnings, minimum GIP£10 per week and maximum GIP£30.17 per week.

**I.50** Interestingly, the Unite union is currently considering commissioning a legal study to review local employment legislation, in comparison to that of the UK<sup>223</sup>.

## Ireland

**I.51** Ireland<sup>224</sup> uses employed and self-employed as categories of worker and workers are categorised depending on their role, the way they undertake their work and their terms and conditions. Jobs are looked at as a whole, including working conditions and a true reflection of the employment relationship. Employed individuals have rights to certain benefit payments whereas self-employed individuals do not generally accrue any rights to benefit payments.

**I.52** Indicators defining **employment** include:

- works for one person or company
- control by someone who directs the work, the way in which it is carried out and where
- set or fixed hours per week or month

<sup>223</sup> <http://www.unitetheunion.org/how-we-help/listofregions/gibraltar/>

<sup>224</sup> Information has been gathered from the Republic of Ireland Revenue [www.revenue.ie](http://www.revenue.ie) and from *Citizens Information* website.

- fixed hourly/weekly/monthly payment
- pay or time off in lieu for overtime
- eligibility for expenses
- no financial risk
- no personal provision of materials or equipment, other than small tools
- cannot subcontract
- covered under employer's public liability insurance.

**I.53** Indicators defining **self-employment** contracting include:

- owns the business
- able to provide the same service to others at the same time
- control over what is done, how, when and where and whether it is done personally
- control over hours of work
- agrees a fixed price for the task
- receives an agreed contract payment with no entitlement to statutory rights including overtime, annual leave, expenses
- is able to profit from the performance of the task
- exposed to financial risk should work be unsatisfactory
- provides materials, equipment and machinery
- free to subcontract
- takes responsibility for investment and management
- provides personal insurance cover.

**I.54** There is a professional services withholding tax in force in Ireland which is deductible at source for professional services that are made to individuals and companies by government departments, local authorities, health authorities and so on. In addition, a Relevant Contracts Tax applies in the construction, forestry and meat processing industries where they are employing sub-contractors. Tax is deducted at 35% from payments unless the sub-contractor has a C2 certificate authorising payment without tax deduction.<sup>225</sup>

## Italy

**I.55** Italian workers come into several categories<sup>226</sup>:

- Subordinate employees – receive a salary to perform intellectual or manual work under the management and control of the company. Subordinate employees are entitled to statutory rights and have good protection against unfair dismissal claims.

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<sup>225</sup> <http://www.revenue.ie/en/personal/circumstances/moving/taxes-payable-ireland.html>

<sup>226</sup> See <http://uk.practicallaw.com/2-503-3122?q=&qp=&qo=&qe=> and <https://research.mbs.ac.uk/european-employment/Portals/0/docs/Bordogna.pdf>

- Project-based workers – self-employed workers collaborating on a specific project that is different to the usual purpose of the employers business. Work is defined by the employer and managed independently by the worker and are therefore not seen as subordinate. Project workers also receive most of the statutory rights.
- Self-employed workers – perform a piece of work or provide a service, by their own effort and without subordination, for remuneration. Self-employed workers receive almost none of the statutory rights.
- Commercial agents – self-employed workers continuously promoting contracts in an area on behalf of the employer.

**I.56 Subordinate employees** hired on fixed term contracts cannot work for more than 36 months. If the employee is an executive, the term is five years. Fixed-term and permanent employees must be treated equally and there is no longer a reason required to agree a fixed-term contract. If these rules are not complied with then the employee is considered to be permanent as is the case if the employee does not comply with the minimum period between fixed-term contracts (10 days if under 6 months or 20 days if over). If re-qualification takes place, compensation of between 2.5 times salary to 12 months' salary is awarded. If a fixed-term contract is unjustly ended then damages also apply according to loss of salary. Part-time employees are required to be treated in the same way as full-time staff and cannot be discriminated against. This includes receiving the same hourly rate salary and annual leave entitlement.

**I.57 Project and self-employed workers** have no limitations on timescale but are related to the project or service being provided. Self-employed workers can claim misclassification, based on a number of factors including:

- hierarchy of the employer
- having set working times
- receiving a salary more than 80% of annual remuneration over two consecutive years
- being in a relationship of more than eight months over two consecutive years
- being assigned a permanent desk at the employer's office.

**I.58 Short-term temporary contracts** have a limit of €5,000 per annum from all employers or €2,000 from a single employer.

**I.59 Agency workers** can be hired on a fixed-term or permanent basis and it is now possible to hire agency workers as apprentices. An exception to the "express motivation rule" has also been provided which enables agency workers to be appointed on a fixed-term contract for a period of 12 months without express motivation. Basic conditions apply that must not be less than the employer's permanent employees receive. Violations of this incur a fine.

## Income tax and social security contributions

**I.60** Employers and employees make social security contributions, paid monthly and dependent on the company's business and the employee's status. Payments are made based on gross annual earnings. Currently employers' rates are 25% to 30% basic with employees paying 10% with a ceiling of €100,123 (employees starting after January 1996).

**I.61** Rates of taxation are progressive:



- up to €15,000: 23%
- over €15,000 and up to €28,000: 27%
- over €28,000 and up to €55,000: 38%
- over €55,000 and up to €75,000: 41%
- over €75,000: 43%

**I.62** Self-employed workers must enrol with Gestione Separata INPS (approximately 28% of the annual income), unless specific rules apply. Certain professionals such as lawyers, engineers and chartered accountants are required by law to contribute to a specific pension scheme.

**I.63** The simplest arrangement is that of **co-worker** working on a fixed-term contract. From 2001 these workers were considered to be more or less an employee for tax purposes and included in the system with tax deductions taking into account level of income and tax deductibles rather than a flat 20% withholding rate. For those undertaking irregular work there is a route whereby the client issues a tax receipt showing the amount less 20% income tax, not including VAT or social contributions but this cannot be used for a significant period of time.

## Spain

**I.64** In Spain<sup>227</sup>, workers providing services to employers can be classified as employees (employment relationships) or independent contractors (civil/mercantile relationships) or self-employed. **Employment contracts** require employees to provide physical or intellectual services in return for payment. Section 1.1 of the Workers' Statute therefore applies to those who voluntarily provide services as an employee under the management of another person (the employer). Only employees with an employment contract are subject to receipt of statutory benefits. The only maximum duration that applies to workers relates to those on fixed-term contracts.

**I.65 Civil/mercantile relationships** apply where a contract is in place for the provision of a service that is rewarded by payment. Employment contracts therefore only apply if broad components of employment are in place (managed by, and dependent upon, the employer, no risk sharing and receives payment).

**I.66** Spain also has a category of **economically dependent autonomous employees** who undertake professional activity personally or directly for profit, regularly for profit for one person or client and a minimum of 75% of income is dependent upon this client. These categories of self-employed workers have a specific legal framework regulating them.

## Implied terms of employment

**I.67** There are a number of common terms implied within employment contracts, as defined in statute and case law. These include:

- a mutual duty of trust and confidence
- the employee's duty to obey the employer's instructions
- the employee's duty to comply with the company's internal rules.

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<sup>227</sup> <http://eurofound.europa.eu/observatories/eurwork/comparative-information/national-contributions/spain/spain-self-employed-workers>

## Income tax and social security contributions<sup>228</sup>

**I.68** Contributions for employees depend upon the category of worker and have limits attached to the rates that are paid. However, as a general rule, employed workers are required to pay social security contributions of around 6.35% whereas the employer is required to contribute around 30% of the employee's earnings.

**I.69** Self-employed workers are immediately eligible for medical social security cover once they register on the 'autonomos' system. Payments are fixed monthly and must be paid regardless of income levels but the levels are variable, depending on the pension income required upon retirement. It is suggested that the majority of workers choose the minimum (currently around 200 euros). An additional payment for temporary incapacity sickness can also be paid. The structure for workers over 50 is slightly different and those over 65 are not required to make any social security payments, other than optional incapacity payments if chosen.

**I.70** Autonomos are also required to pay income tax quarterly and can be subject to customer deductions of up to 15% that is paid to the tax office. However, the autonomo does get credit for this when completing their tax return as *retenciones* are offset against the quarterly tax bill and credited against tax payable.

**I.71** It is therefore clear that Spanish employers are required to pay significantly higher social security rates for employees as opposed to self-employed workers, which could explain the high level of self-employment in Spain.

## South Korea

**I.72** Employees in South Korea<sup>229</sup> come under the Labor Standards Act and have categories of permanent, fixed-term and part-time. **Agency workers** (dispatched employees) are employed by temporary agencies that provide services to user companies under a contract. The employment relationship exists with the temporary agency. **Independent contractors** come into categories such as sub-contractors who usually work at a company's premises but under the direction of the sub-contractor not the user company. Employees and dispatched employees are entitled to statutory rights including severance and annual leave whereas other workers, including independent contractors, have no such entitlement.

**I.73** Fixed-term employees can be used for up to two years, after which time they are considered to be permanent. Dispatched employees can also be used for up to two years and again the user company is required to employ them on a permanent or fixed-term basis.

## Income tax and social security contributions

**I.74** Rates are variable (and include 10% resident surtax):

- up to KRW12 million: 6.6%
- between KRW12 million and KRW46 million: 16.5%
- between KRW46 million and KRW88 million: 26.4%
- between KRW88 million and KRW150 million: 38.5%
- KRW150 million: 41.8% (since 2014)

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<sup>228</sup> <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxation-international-executives/spain/pages/other-taxes-levies.asp>

<sup>229</sup> <http://uk.practicallaw.com/6-508-2342>

### **I.75** Social security tax falls into four categories:

- National pension
  - 4.5% employer
  - 4.5% employee
- National health insurance
  - 2.995%, + 6.55% employer
- Employment insurance
  - 0.9% to 1.5% employer
  - 0.65% employee
- Workers' compensation insurance
  - 0.6% and 34% employer

## **United States**

**I.76** In the United States<sup>230</sup>, employees are entitled to all employment law provisions including union, health and safety, minimum wage, overtime and unlawful discrimination<sup>231</sup>. The definition of an independent contractor is well established in the USA but it is the employer who is responsible for unpaid taxes and social security bills if an independent contractor is found to be a 'disguised' employee which can be detrimental to some workers that the law is designed to protect.

**I.77** Independent contractors have a similar profile to those in the UK and are excluded from statutory protection at federal and state level. Workers correctly classified as contractors cannot therefore sue their employer under employment discrimination laws, alleging that they have been the subject of unlawful workplace bias or harassment.

**I.78** Employers have increasingly tended to use workers from agencies where they operate as the employer as this can be deemed to be acceptable in many cases but it can result in a challenge of "joint employer" status due to shared control in some circumstances. Misclassification of employees' cases are increasingly common and are brought by employees and employers under employment and tax statutes.

**I.79** Distinctions between employee and contractor status are generally not linked to time, more to a series of areas including:

- control over how the work is performed
- whether the service is integral to the employer's business
- the employee's opportunity for profit or loss
- the employee's investment in equipment or materials
- specialist skills required for the role.

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<sup>230</sup> See <http://www.uscis.gov/e-verify>

<sup>231</sup> <http://www.bls.gov/news.release/empst.nr0.htm>

**I.80** Whilst there are no specific factors in place to determine whether a worker is an employee or independent contractor, the test for employment or independent contracting is based on behaviour control, financial control, and the relationship of the parties<sup>232</sup> (IRS Pub. 1779 Employee or Independent Contractor).

**I.81** Indicators that are used to determine employment status are similar to the UK and individuals must meet all three of the following tests to be considered an independent contractor (known as the ABC test):

- A behavioural factors that look at control – i.e. if the worker is free from the company's control in performing the services
- B financial factors including type of payment (e.g. flat fee or time and materials) and whether there are multiple clients – i.e. if the worker performs their duties outside the usual course and place of the company's business
- C the type of relationship including contracts, benefits and mutuality of obligation – i.e. if the worker's business is established and independently engaged.

**I.82** This ABC test in relation to independent contractor status has become prominent and referred to in US case law.<sup>233 234</sup>

**I.83** Companies are required to consider all of these tests and bear in mind that situations vary and quick assumptions cannot be made. As a consequence, as in the UK, it can take some considerable time to make an official decision on a worker's employment status (often up to six months). Should a worker have been misclassified, the US tax authorities demand back taxes, social security, Medicare and other federal and state taxes and benefits in full, plus the same again as a penalty.

**I.84** One particular state, Connecticut (CT), has provided its own guidance on the application of the ABC test, as outlined below.<sup>235</sup>

**STATE OF CONNECTICUT  
EMPLOYMENT SECURITY DIVISION  
UNEMPLOYMENT COMPENSATION TAX DIVISION**

**SELF-ASSESSMENT OF THE EMPLOYER-EMPLOYEE RELATIONSHIP FOR CT UNEMPLOYMENT TAXES**

*The determination of independent contractor status versus employee status is often a complex decision. Connecticut unemployment law states that employment is any service performed under an express or implied contract of hire that creates the relationship of employer and employee. Workers who are employees under the common law definition of master and servant (the standard applied by the Internal Revenue Service) are therefore covered for state unemployment purposes. In Connecticut however, irrespective of whether the common law relationship of master and servant exists, the law holds that service will be considered employment subject to the act unless the service recipient can establish compliance with Connecticut General Statutes Section 31-222(a)(1)(B)(ii), commonly referred to as the "ABC test" which is outlined below.*

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<sup>232</sup> <http://www.irs.gov/pub/irs-pdf/p1779.pdf>

<sup>233</sup> <http://www.lexology.com/library/detail.aspx?g=02835f48-6ae6-4565-8022-916d91c5274c>

<sup>234</sup> <http://www.natlawreview.com/article/new-jersey-clarifies-independent-contractor-classification-test>

<sup>235</sup> <https://www.ctdol.state.ct.us/uitax/abctest.doc>

*To be considered an independent contractor, an individual must meet all three of the following tests.*

- A. The worker must be free from direction and control in the performance of the service, both under the contract of hire and in fact. (Essentially, this is the common law definition.)*

*AND*

- B. The worker's services must be performed:*

*EITHER*

*(1) Outside the usual course of the employer's business*

*OR*

*(2) Outside all of the employer's places of business.*

*AND*

- C. The worker must be customarily engaged in an independently established trade, occupation, profession or business of the same nature as the service being provided.*

*It is important to note that test A above will not be satisfied if the person or persons for whom the service is performed retain the right to exercise direction and control over the service, even when the right is not used. Also, bear in mind that an individual who forms a business in response to an offer of work as an independent contractor will meet neither the "customarily engaged" nor the "independently established" criteria of test C.*

*The following form is designed to allow you to perform a self-examination of the status of workers in your business whom you consider to be independent contractors.*

#### **SELF-ASSESSMENT OF THE EMPLOYER-EMPLOYEE RELATIONSHIP FOR CT UNEMPLOYMENT TAXES**

***The determination of a worker's status is both technical and complex. This self-assessment is designed only as a guide; it is not an official Department of Labor form. If you have questions concerning the employee versus independent contractor status of a worker please contact your local Unemployment Compensation Field Audit Unit [...]***

*As an aid to determining whether an individual is an employee (EE) under the common law rules or an independent contractor (IC), twenty factors or elements have been identified as indicating whether sufficient control is present to establish an employer - employee relationship. These twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee.*

*These twenty factors are designed only as guides for determining whether an individual is an employee. The degree of importance of each factor varies depending on the specific situation. **No single fact or small group of facts is conclusive evidence of the presence or absence of control.** There will be situations where some factors do not apply. Careful scrutiny is required to assure that formalistic aspects of an arrangement designed to achieve a particular status do not obscure the actual substance of the arrangement. (That is, if the relationship of employer-*

*employee exists, the designation of the relationship by the parties as anything other than that of employer-employee is immaterial.)*

**THE COMMON LAW IS ALSO TEST "A" OF THE "ABC" TEST FOR CT UNEMPLOYMENT**

[continued on next page]

#	FACTOR	DESCRIPTION	EE	IC	DNA
A1	INSTRUCTIONS	Does the firm provide instructions or procedures the worker is expected to follow in doing the work?	YES	NO	
A2	TRAINING	Does the firm provide training to the worker?	YES	NO	
A3	INTEGRATION	Does the continuation of the scope and function of the firm depend appreciably upon the services of the worker?	YES	NO	
A4	PERSONAL SERVICE	Does the firm require the personal services of the worker to get the job done?	YES	NO	
A5	ASSISTANTS	Does the firm hire, supervise and pay for any assistants needed by the worker to do the work?	YES	NO	
A6	CONTINUING RELATIONSHIP	Does the relationship between the firm and the worker contemplate continuing or recurring work?	YES	NO	
A7	HOURS OF WORK	Does the firm set the hours of work or the amount of hours to be worked by the individual?	YES	NO	
A8	FULL TIME	Is the worker required to devote full time to the firm during the relationship?	YES	NO	
A9	PLACE OF WORK	Is the individual required to perform the work on the firm's premises?	YES	NO	
A10	ORDER OR SEQUENCE	Is the worker required to perform the services in an order or pattern set by the firm?	YES	NO	
A11	REPORTS	Is the worker required to give oral or written reports to the firm on the state of the work?	YES	NO	
A12	PAYMENTS	Is the worker's pay based upon time worked?	YES	NO	
A13	EXPENSES	Does the firm pay the worker's expenses?	YES	NO	
A14	TOOLS & MATERIALS	Does the firm furnish the tools and materials needed to do the work?	YES	NO	

#	FACTOR	DESCRIPTION	EE	IC	DNA
A16	PROFIT OR LOSS	Can the worker realize a profit or suffer a loss as a result of the services performed for the firm?	NO	YES	
A7	WORKS FOR MORE THAN ONE FIRM	Does the individual work for a number of firms at the same time?	NO	YES	
A18	OFFERS SERVICES TO THE PUBLIC	Does the worker offer this service to the general public?	NO	YES	
A19	RIGHT TO FIRE	Does the firm have the right to discharge the worker at any time?	YES	NO	
A20	RIGHT TO QUIT	Does the individual have a right to terminate the relationship at any time without incurring liability?	YES	NO	

**IRRESPECTIVE OF THE RESULT OF THE COMMON LAW DETERMINATION ABOVE, YOU MUST ALSO SATISFY BOTH TEST B AND TEST C BELOW.**

**TEST B: ANSWERING EITHER OF THESE QUESTIONS AS IC WILL SATISFY THIS TEST**

#	FACTOR	DESCRIPTION	EE	IC	DNA
B1	OUTSIDE USUAL COURSE OF EMPLOYER'S BUSINESS	Is the service provided part of the employer's normal business operation?	YES	NO	
B2	OUTSIDE EMPLOYER'S PREMISES	Does the individual perform any of the work on the firm's premises?	YES	NO	

[continued on next page]



**TEST C: THIS TEST MUST BE APPLIED TO EACH INDIVIDUAL. SIMILARLY SITUATED WORKERS MAY DIFFER IN THEIR RESPONSE TO THIS FACTOR.**

#	FACTOR	DESCRIPTION	EE	IC	DNA
C1	ENGAGED IN AN INDEPENDENTLY ESTABLISHED BUSINESS OF THE SAME NATURE AS SERVICE PROVIDED	Is the worker <i>customarily engaged</i> in an <i>independently established</i> trade, business, occupation or profession of the same nature as the service being provided? (Items A13-A20 may help to determine the existence of a business.)	NO	YES	

**POTENTIAL EVIDENCE TO SUPPORT YOUR DETERMINATION REGARDING TEST C**

<i>Business license</i>	<i>Letterhead stationary</i>	<i>References of other clients</i>
<i>Business liability insurance certificate</i>	<i>Advertisements in yellow pages, newspapers, trade journals, etc.</i>	<i>Registration for or collection of state sales tax on the services provided.</i>
<i>Business card</i>	<i>Bills or invoices with a logo or trade name</i>	<i>Federal identification number for the business.</i>

# J Terms of reference

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## Background

The boundary between employment and self-employment has not kept pace with changing work patterns, especially in recent years. Many people work for more than one business and can be classed as employed for one job and self-employed for other work. The growth of freelancing as a way of conducting business had led some to suggest this is a ‘third way’ between employment and self-employment.

There are significant tax and NICs differences between employed and self-employed status. Getting the status wrong in a working arrangement can be very costly for the business in particular and often for the individual. These potential tax and NICs benefits and risks drive business behaviour, exemplified by many of the personal service companies that are in use (though many are simply sensible vehicles for the taxpayer’s operations).

## Previous OTS work

The distinction between the employed and self-employed was highlighted as a major fault line and source of complexity in the OTS reliefs review and the small business review. The first stage of the latter review reported specifically on IR 35 with recommendations for improving its operation.

The OTS noted that it is important for the tax system to fit with the real world but in many instances case law is complex and difficult to apply, for large and small businesses alike. Offering more certainty to individuals and businesses would be a useful simplification.

## The OTS employment status project

The Government has therefore commissioned the Office of Tax Simplification to examine the dividing line between employment and self-employment and whether it is drawn in the right place and in the right way. In carrying out their work the OTS will consider:

- Whether the UK’s current employment status tests result in real uncertainty and if so, for what sections of the workforce and in which areas.
- Sectors and types of engagement with the labour market where difficulties in administering the tax rules are relatively common for any or all of those involved with the tax system.
- How well current rules and guidelines fit with situations where individuals have multiple roles; whether the key distinction is between working and not working.
- Trends in employment law
- HMRC guidance and advice
- The special cases regulations, primarily as evidence of existing difficulties with the main tax rules.
- The scope for simplification through the increased use of digitisation.
- International comparisons to the UK approach to dealing with employment status and the experience of other countries in managing their approach.

The review will not consider:

- IR 35: previous OTS work has made recommendations in this area and the government decided how to take the issues forward. The recent report of the House of Lords Economic Affairs sub-committee has also examined the area.
- The Construction Industry Scheme: CIS has overtones of employed/self-employed issues but is not directly relevant to the OTS project; HMRC are also currently consulting on proposals for improving CIS.
- the expenses rules for employed and self-employed people

The review should have regard to:

- The impact on employers and employees of any changes;
- The cost/benefit to the Exchequer;
- HMRC operational impacts;
- Interaction with employment law, including EU aspects;
- The on-going project on PAYE/NICs operational integration;
- Fairness and consistency of treatment of taxpayers; and
- The need for anti-avoidance measures.

The Office has been asked to produce a report in time for Budget 2015. The intention is that this report will contain any appropriate 'quick wins' that it may be possible to take forward quickly. However, it is likely that if the report points the way to significant reforms, these would be for the next government to consider.

The Office's work will be informed by consultation with interested parties, including forming and working with a consultative committee.

### **Office of Tax Simplification contacts**

This document can be found in full on our website at:

<https://www.gov.uk/government/organisations/office-of-tax-simplification>

If you require this information in an alternative format or have general enquiries about the Office of Tax Simplification and its work, contact:

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