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Personal service companies: introduction of IR35

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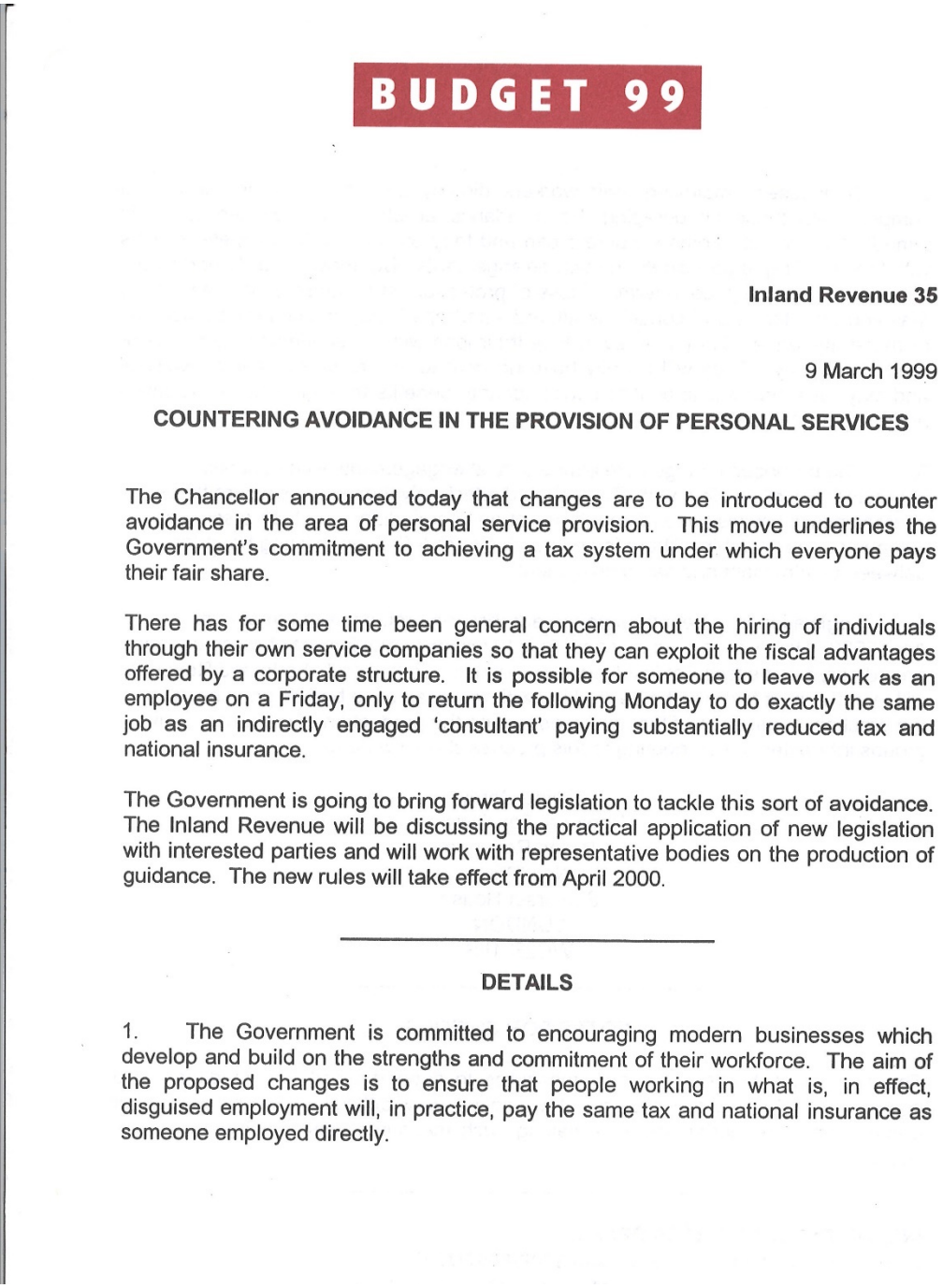

BUDGET 99

Inland Revenue 35

9 March 1999

COUNTERING AVOIDANCE IN THE PROVISION OF PERSONAL SERVICES

The Chancellor announced today that changes are to be introduced to counter avoidance in the area of personal service provision. This move underlines the Government's commitment to achieving a tax system under which everyone pays their fair share.

There has for some time been general concern about the hiring of individuals through their own service companies so that they can exploit the fiscal advantages offered by a corporate structure. It is possible for someone to leave work as an employee on a Friday, only to return the following Monday to do exactly the same job as an indirectly engaged 'consultant' paying substantially reduced tax and national insurance.

The Government is going to bring forward legislation to tackle this sort of avoidance. The Inland Revenue will be discussing the practical application of new legislation with interested parties and will work with representative bodies on the production of guidance. The new rules will take effect from April 2000.

DETAILS

1. The Government is committed to encouraging modern businesses which develop and build on the strengths and commitment of their workforce. The aim of the proposed changes is to ensure that people working in what is, in effect, disguised employment will, in practice, pay the same tax and national insurance as someone employed directly.

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Summary

In the 1999 Budget the Labour Government announced that new rules would be introduced in the tax treatment of personal service companies (PSCs), to prevent the exploitation of this corporate structure as a means to avoid tax. These rules are usually called IR35, after the number of the Budget press notice which covered this change. Individuals working in a number of fields - Information Technology (IT) in particular - often set themselves up as a PSC, providing their services as a consultant to a client, rather than, say, working directly for that client on their payroll as their employee. The client pays the service company for the work they have done, without deducting income tax or National Insurance contributions (NICs) under PAYE.

There are several potential *tax* advantages to this type of arrangement: first, the range of expenses which the PSC may set against its taxable profits will be much wider than that allowed an employee to set against his taxable income. Second, there will be a cashflow benefit in avoiding tax being deducted at source each month. Third, the individual may be in a position to receive dividends out of their service company, as an alternative to only being paid a salary, an arrangement which is likely to mitigate their liability to NICs.

Following a long and contentious consultation exercise, provisions were introduced in the *Finance Act 2000,* and came into effect from 6 April 2000. In brief, the off-payroll working rules cover any engagement where an individual provides services under a contract between a client and an intermediary and, but for the presence of the intermediary, that person would be considered the client's employee for tax purposes. In these cases, the intermediary is required to account for tax on the payment made by the client in the same way as employee earnings.[1]

This note gives some background to the use of personal service companies to avoid tax, before discussing the introduction of IR35 and its first years of operation.

Although IR35 has remained controversial in the twenty years since it was first announced, and many stakeholders have made the case for the regime to be scrapped, the rules have remained on the statute books. In the 2016 Budget the then Chancellor George Osborne announced that from April 2017 public sector bodies would have new duty to ensure any contractors that they took on were complying with IR35.[2] At the time Ministers ruled out introducing a similar duty on the private sector.[3] However, in the Autumn 2017 Budget the Government announced that in 2018 it would "carefully consult on how to tackle non-compliance in the private sector, drawing on the experience of the public sector reforms."[4] A consultation was launched on 18 May, which closed on 10 August.[5] To date no further announcements as to potential reforms to IR35 have been made.[6] A second note discusses these developments.[7]

1 Detailed guidance on the rules is on HM Revenue & Customs' site.
2 HC Deb 16 March 2016 c956. see also, *Budget 2016,* HC901 March 2016 p43; HMRC, *Off-payroll working in the public sector,* March 2016
3 *Off-payroll working in the public sector: reform of the intermediaries legislation,* May 2016 pp36-8
4 *Autumn Budget 2017,* HC 587, November 2017 para 3.7
5 HM Treasury press notice, *Government to consult on tax avoidance in the private sector*, 18 May 2018
6 See PQ167869, 5 September 2018
7 *Personal service companies and IR35,* CBP5976, 6 September 2018.

1. Introduction

1.1 The use of PSCs

Individuals working in a number of fields often set themselves up as a personal service company (PSC). In some cases, the purpose for doing so is to mitigate the individual's tax liability. It may be possible for someone to leave work as an employee on a Friday, only to return to the client in question the following Monday to do the same job, but as a consultant supplied by their own PSC. By providing their services this way, the individual does not need to be treated as the client's employee, and their client pays the service company for the work they have done without deducting income tax or national insurance contributions (NICs) under PAYE.

Without the intermediary of the PSC, the individual's employment status would be determined by their relationship with the client company. The question would then be whether they were an employee or self-employed. In this type of case where someone is doing the same job they had done before, it would be clear that the individual was an employee, and would be taxed as such.

There are a number of potential *tax* advantages to this type of arrangement: first, the range of expenses which the PSC may set against its taxable profits will be much wider than that allowed an employee to set against his taxable income. Second, there will be a cashflow benefit in avoiding tax being deducted at source each month. Third, the individual may be in a position to receive dividends out of their service company, as an alternative to only being paid a salary, which is likely to mitigate their liability to NICs.

A good explanation of the way PSCs have been used to avoid tax was given by Lord McIntosh of Haringey, speaking for the Government when the House considered the NICs legislation for IR35 in July 1999:

> The problem can be explained quite simply. A worker will normally pay a different amount of tax and national insurance contributions depending on whether he or she is an employee or self-employed. But some people who, if this distinction was applied to their circumstances, would count as employees, manage to avoid many of the consequences of employee status by setting up or acquiring an "off-the-shelf" limited company.
>
> That means that the engager, the client, who would otherwise be their employer, contracts instead with the company for the supply of their services. That engager then does not have to operate PAYE or pay employer's national insurance contributions.
>
> The worker is then free to decide how to take the money out of his company. He can take it out in the form of dividends, which are not subject to national insurance contributions.
>
> Let me give an example of how this actually works.
>
> An individual with an income in the year of around £30,000 to £35,000, paid through a service company, might pay company taxes and running costs and expenses such as travel, subsistence and pension contributions of about £7,000; take out just over

> £3,000 as salary, just enough to qualify for state benefits; take out dividends of £11,000; and distribute £11,000 of dividends to his wife. By doing so, he would achieve a saving of £6,000 in tax and national insurance contributions when compared to the amount of tax and national insurance contributions he would pay if engaged directly as an employee of the client to whom he is selling his services. It is a very big saving.[8]

It is important to note that setting up a PSC may provide many benefits that have nothing to do with saving tax. PSCs provide flexibility in working relationships, which may be invaluable for those who have to respond to peaks and troughs in the demand for their services.

As an example, at the time IR35 was being considered, many client companies were engaging IT specialist on a short-term basis to ensure their computer systems were millennium-compliant. Short-term one-off projects like this have meant that freelance consulting is widespread in the IT sector. It has also been suggested that the use of PSCs grew strongly in the mid-1990s as many individuals who had been laid off by their employer found that using this corporate structure meant they could their professional services at competitive terms.[9]

1.2 Earlier debates on the misuse of PSCs

In 1981 the then Conservative Government brought forward proposals to prevent the use of intermediary companies as a means of avoiding tax, although it decided subsequently to leave the law unchanged.

When the Finance Bill was published after the 1981 Budget, the Bill included provision to require companies to deduct tax from the payments they made to agency workers who provided their services through a company. A press notice issued at the time gave details:

> Clause 34 of the Finance Bill supplements the provisions of Section 38 of the Finance (No 2) Act 1975, which applies PAYE to payments made to workers supplied by agencies. This Notice describes the general effect of the Clause.
>
> Section 38 of the Finance (No 2) Act 1975 provides for agency workers to be taxed under Schedule E, in the same way as employees, and thus for payments made to them to be subject to deduction of tax under PAYE. However, while the Section applies PAYE to payments of remuneration to individuals, it does not do so to payments to companies. A substantial number of individuals obtaining work through agencies now do so through the medium of a company, with the result that the provisions of Section 38 do not apply. In many cases this has led to a loss of tax; it also puts at a disadvantage agency workers who are paid as individuals.
>
> Clause 34 of the Finance Bill therefore requires a deduction at a rate of 30 per cent to be made from payments to companies obtaining work through agencies. Companies will be entitled to set off the deduction against their corporation tax liability, any excess being repayable. The overall effect of this will be that,

8 HL Deb 20 July 1999 c921
9 "Threat to flexibility", *Financial Times*, 21 July 1999

> where the true tax liability is at present being met, no more tax will be payable than under existing law.[10]

At the Committee stage of the Bill, Peter Rees, then Minister of State at the Treasury, announced that the Government had decided to withdraw the clause, and to undertake consultation with the aim of bring forward revised proposals the following year. The Minister explained that the clause "does not meet the problem in the most adroit way. There is perhaps the impact on cash flow, that the companies concerned might think a little bit harsh."[11]

In November 1981 the Inland Revenue published a consultation paper on this issue; an extract is reproduced below:

> **Background**
>
> 3. The provisions of Section 38 of the Finance (No 2) Act 1975 were introduced to ensure that temporary agency workers who work under conditions which are typical of employment rather than self-employment are, like employees, taxed under Schedule E and subject to PAYE. Previously, the special nature of the legal relationship between agency, client to situations where an agency worker, working side-by-side with permanent employees in similar conditions, was taxed on a different basis merely because his or her services were supplied through an agency.
>
> 4. Section 38 applies deductions under PAYE to payments made by agencies to individual agency workers. However, it does not require a deduction to be made where the payment is from the agency to a company. There has therefore been an increasing tendency for agency workers to operate through companies, so that the provisions of Section 38 do not apply. The Government decided that the resulting loss of tax, and the relative financial advantage enjoyed by agency workers operating through companies, required some legislative correction.
>
> Accordingly, Clause 34 of the Finance Bill 1981 put forward proposals which aimed to achieve more consistency between the tax treatment of the individual employee (or the agency worker operating as an individual) and that of the agency worker operating through a company. These provided for a deduction of 30 per cent to be made from payments made where the services of the agency worker were provided through the medium of a company. The company would have been entitled under the proposals to set off the deduction against its corporation tax liability, any excess being repayable to it.
>
> **The scope for change**
>
> 5. The Government have taken careful note of the suggestions and comments put to them by those who made representations on Clause 34. The Government's view is that whatever modification of the original proposals is finally adopted, the main provision - the deduction of tax at source from payments to agency workers operating through companies - should remain a feature of the scheme. Each of the options put forward in this paper would therefore operate on that basis.

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[10] Inland Revenue press notice, 3 April 1981. At this time the standard rate of income tax was 30%.

[11] Standing Committee E, 4 June 1981, c422. The House was also informed of this decision by means of a written answer (HC Deb 4 June 1981 c401W).

> The options are:
>
> - allowing companies generally to set-off deductions suffered against their PAYE remittances to the Collector of Taxes; or
> - entitling companies which satisfy certain qualifying conditions to be paid in full in the following circumstances:
> - on production to their agencies of a special Inland Revenue 'exemption' certificate; or (as an alternative scheme)
> - on receipt by their agencies of a special 'letter of authority' issued by the Inland Revenue for that purpose.[12]

However, in April 1982 Treasury Minister Nicholas Ridley announced that the Government had decided **not** to go ahead with this proposal:

> In reply to a Parliamentary Question asking the Chancellor of the Exchequer whether he has yet come to any conclusion following responses made to the Government's consultative paper, "The Taxation of Agency Workers Operating through Companies", the Financial Secretary to the Treasury, the Hon Nicholas Ridley MP, gave the following Written Answer yesterday:
>
> "Yes. There have been a substantial number of responses to the paper. These have recognised that a problem exists in this area, but have expressed a wide range of differing views about what would be the appropriate action in relation to it. Having given these careful consideration, we have decided for the time being not to introduce further legislation on this topic - though this in no way precludes the possibility of our doing so at a future date, if some statutory provision appears necessary and appropriate.
>
> Instead, we propose for the present that the Inland Revenue should make use of their existing powers under Section 16 of the Taxes Management Act 1970, to require regular returns from agencies of payments made to and information about agency worker companies. The information in these returns will be used in a systematic way to monitor tax compliance by these companies and where necessary to improve it."[13]

In February 1993 it came to public attention that John Birt, then the Director-General of the BBC, provided his services not as a BBC employee but as a consultant, hired from a limited company of which he was the sole shareholder. As the *Financial Times* reported, this was common practice for many freelance service providers, though not for the head of the BBC:

> Tax consultants say arrangements similar to Mr John Birt's employment contract with the BBC are common among entertainers, computer consultants, North Sea divers, fishermen and non-executive directors of large companies ... Employers and executive recruitment specialists expressed surprise that the Revenue would grant freelance consultancy status to executives earning their living predominantly from one source. Mr Peter Brown, chairman of Top Pay Research Group, which advises non-executive directors, says it is 'virtually inconceivable' that a permanent chief executive would be employed on a freelance

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12 Inland Revenue, *Taxation of agency workers operating through companies: a consultative paper*, November 1981 pp1-3. At the time the Revenue had responsibility for administering direct taxes. The department was merged with HM Customs & Excise to form HMRC in April 2005.

13 Inland Revenue press notice, 7 April 1982

> basis. Mr John Courtis of Courtis & McManus, the headhunters, warns that companies employing executives as freelances could be held liable for outstanding tax liabilities.[14]

Indeed, on 1 March 1993 the BBC announced that this arrangement had been changed and that Mr Birt's future status would be as employee.[15] Although, understandably enough, no details on Mr Birt's tax affairs were published at the time, the Conservative Government of the day was asked whether it would change the law in this area:

> **Mr. Sedgemore:** To ask the Chancellor of the Exchequer what plans he has to clarify the definition of employee in relation to the payment of PAYE in connection with the payment of fees to private companies in lieu of salary.
>
> **Mr. Dorrell:** We have no plans to do so. Whether an individual is an employee for tax purposes is a question of fact and general law and will depend, therefore, on the circumstances of the particular case.[16]

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14 "Birt-type deals said to be common", *Financial Times*, 2 March 1993. The controversy was recalled at the time of the 1999 Budget when IR35 was first announced: "Warning on 'slave' changes", *Times*, 10 March 1999.

15 "Leading Article: John Birt Inc", *Financial Times*, 2 March 1993

16 HC Deb 5 March 1993 c337W

2. The Labour Government's proposals

2.1 The March 1999 Budget

At the time of the March 1999 Budget, the Government announced that new rules would be introduced in the tax treatment of 'personal service provision', to take effect from April 2000. Details were provided in a press notice issued at the time of the Budget:

> Businesses employing their workers directly say that they are unable to compete with those encouraging the avoidance at which the new legislation is aimed. As a result, ordinary workers can find they are unable to compete for jobs with those willing to participate in such arrangements. But those who do participate often have to pay a price in terms of loss of protection under employment law. They may find their terms and conditions altered - perhaps losing entitlement to sick pay or maternity leave. They may even lose their jobs without entitlement to notice or redundancy pay. They will usually have no right to any claim for unfair dismissal and may lose their entitlement to social security benefits through a failure to make adequate contributions.
>
> The proposed changes are aimed only at engagements with essential characteristics of employment. They should affect only those cases where these characteristics are disguised through use of an intermediary - such as a service company or partnership. There is no intention to redefine the existing boundary between employment and self-employment. Legislation is to be introduced to address the problem with effect from April 2000. However, a primary concern is to minimise any impact of these changes on ordinary businesses not involved in avoidance. To this end, the Inland Revenue will over the next few months be working with representative bodies on aspects of the practical application of the new rules and on the production of guidance.[17]

To this end, the Inland Revenue consulted stakeholders …

> **Dr. Cable:** To ask the Chancellor of the Exchequer in what form he proposes to implement his proposals on tax avoidance set out in Inland Revenue Press Release 35.
>
> **Dawn Primarolo:** The proposals will be legislated in the Finance Bill 2000. They will provide a mechanism for looking through a contractual relationship, where services provided through an intermediary, such as a company, but the underlying relationship between the worker and the client has the characteristics of employment. In those circumstances, the engagement will be treated as employment for the purpose of tax and National Insurance. The Inland Revenue is presently working with interested parties on details of the practical application of the proposals.[18]

… and published details of how the new rules would work in practice:[19]

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17 Inland Revenue Budget press notice IR35, *Countering avoidance in the provision of personal services*, 9 March 1999
18 HC Deb 12 May 1999 c166W
19 *Proposed New Rules on the Provision of Personal Services*, March 1999

PROPOSED NEW RULES ON THE PROVISION OF PERSONAL SERVICES : SUMMARY OF A POSSIBLE APPROACH

This summary is for use as basis for discussion but is not a consultation document. This summary should not be taken as a statement of the form new rules will eventually take and is not intended to serve as guidance.

The purpose of the proposed new rules is to remove opportunities for the avoidance of tax and Class 1 national insurance contributions (NICs) which can arise where an engagement is routed through an intermediary (or intermediaries). The changes are not designed to prevent a worker providing his or her services through a third party but should remove any tax/NICs advantages of doing so. This note sets out proposals for new rules.

The proposals can be split into three parts:
Part 1 identifies the engagements caught by the proposed new rules;
Part 2 sets out how tax and NICs might be charged where the new rules apply;
Part 3 deals with cases where the new rules are not properly applied.

1) Identifying engagements where the proposed new rules would apply
It is proposed that the new rules will:

- **apply where:**
  - an individual ('the worker') holds an office with or performs services for another person ('the client') where the client has a right of supervision, direction or control as to the tasks undertaken or the manner in which they are performed and;
  - the worker or services are provided under a contract between the client and an intermediary (e.g. a service company or a partnership of which the worker is a member);
- **not apply where:**
  - the worker's services are supplied incidentally to the supply of materials and/or equipment (e.g. where a lorry and driver are supplied together) or
  - where the client is an individual not in business (i.e. services for a householder should not be affected) or
  - an engagement is 'exempt' (see below).

The aim is to minimise any impact on those not involved in avoidance. It is proposed, in general terms, that payments by a client to an intermediary with respect to a particular engagement should be exempt from the new rules – provided that:

- any remuneration by the intermediary with respect to that engagement will be in a form subject to tax and NICs and
- the intermediary will itself account fully for PAYE and NICs.

It would be inappropriate and burdensome to require a client to check that the intermediary had in practice done this. What is required is a system to allow clients, or potential clients, to check (quickly, easily and at minimum cost) whether or not they can make payments gross.
The only workable approach would seem to be a certification scheme. In broad terms, an intermediary undertaking to pay workers only in a form chargeable under Schedule E and subject to national insurance should be able to apply to be what we will describe as 'certified agency'.
The use here of the term 'agency' is perhaps a little misleading. There would be no need to restrict certification to bodies which are employment agencies in the traditional sense. At this stage, there seems no reason not to allow any intermediary to apply for certification where they account for PAYE/NICs on all payments which are effectively in return for their workers' services.

The idea is that the Inland Revenue would maintain a constantly updated public register of certified agencies incorporating instant access and a helpline facility. The certification process itself should obviously be as quick and simple as possible - ideally something very much akin to self-certification. To allow such an approach to operate effectively, ease of certification would need to be accompanied by appropriate penalties for wrongly obtaining, or using, certification.

2) Tax and NICs treatment where the new rules apply

Again in very broad terms, the idea is that where a particular engagement comes within the terms of the legislation and payment made is *not covered by the exemption,* the worker will (for the purposes of tax and NICs only) be deemed to be an employee of the client. The tax and NICs liabilities of the client intermediary and worker would be dealt with as follows:

The client

The client will account for PAYE/NIC on relevant payments made to the intermediary or to the worker – broadly following existing PAYE/NICs rules.

The intermediary

a) Intermediaries who are companies

- Gross receipts from the client will be treated as taxable receipts of the company in the normal way. Income tax deducted by the client under PAYE and primary Class 1 NICs will be allowed as deduction in computing the company's profits.
- In this way, the intermediary need pay no Corporation Tax on the receipts provided the net amount received is paid out to workers as 'salary' – because the salary and the tax/NICs deducted will all qualify as deductions in computing profits for Corporation Tax purposes.

b) Intermediaries who are partnerships where the worker is a partner

The partnership will exclude amounts received net of tax/NICs when calculating profits. This will mean that the partners pay no Schedule D tax or Class 4 national insurance on the income.

c) Other intermediaries

We expect most other intermediaries to become certified agencies. Where they do not, gross receipts from the client will be treated as taxable receipts of the business in the normal way. Income tax deducted by the client under PAYE and primary Class 1 NICs will be allowed as deduction in computing the profits of the business.

The worker

- will be subject to tax (Schedule E) and national insurance (primary Class 1) on remuneration from the deemed employment (both mainly accounted for by the client);
- will be able to deduct expenses allowable under the general Schedule E rules;
- will be able to receive salary tax/NIC free from an intermediary (within a fixed time limit) – up to the amount of net of PAYE/NIC payments received by the intermediary.

3) Failure cases

There will clearly need to be measures to deal with those cases where a client fails to deduct PAYE/NIC in a case where no certification exemption is held by the intermediary. However, it does not seem appropriate for this to necessitate the unwinding of what has subsequently happened within the intermediary nor for the worker to be chargeable on these sums as income from the 'deemed employment'. The intention is that the client (rather than the intermediary or worker) would be held to account in such cases of client failure. However, as described previously, the intermediary would be held to account where certification is wrongly obtained and/or used.

As noted here, the Government proposed that the new rules would apply where the client company had a **"right of supervision, direction or control"** over the individual's work. This test mirrored some of the criteria used determine the boundary between employment and self-employment.

There is no statutory test to determine employment status for tax purposes. The question whether someone is employed or self-employed is determined on the basis of criteria established by judicial decisions. In the past, HM Revenue & Customs' guidance on employment status has indicated the points which influence the courts decision in these cases, by giving a series of questions:

> **Employed** - if you answer yes to most of the questions you are likely to be employed:
>
> - Do you have to do the work yourself?
> - Can someone tell you where to work, when to work, how to work or what to do?
> - Can someone move you from task to task?
> - Do you have to work a set number of hours?
> - Are you paid a regular wage or salary?
> - Can you get overtime pay or bonus payments?
> - Are you responsible for managing anyone else engaged by the person or company that you are working for?
>
> **Self-employed** - if you answer yes to one or more of the questions you are likely to be self-employed.
>
> - Can you hire someone to do the work, or take on helpers at your own expense?
> - Can you decide where to provide the services of the job, when to work, how to work and what to do?
> - Can you make a loss as well as a profit?
> - Do you agree to do a job for a fixed price regardless of how long the job may take?
> - If you can't answer yes to any of the above questions, you are still likely to be self-employed if you can answer yes to most of the following questions.
> - Do you risk your own money?
> - Do you provide the main items of equipment (not the tools that many employees provide for themselves) needed to do the job?
> - Do you regularly work for a number of different people and require business set up in order to do so?
> - Do you have to correct unsatisfactory work in your own time and at your own expense?[20]

However, applying these tests in practice can be difficult. Writing in 2001 Judith Freedman, Professor of Tax Law at Oxford, noted that the

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[20] HMRC, *Employed or self-employed for tax and National Insurance contributions ES/FS1*, June 2008

strong growth in PSCs had been one factor in making these types of classification much more problematic:

> Working patterns have changed significantly over the past 20 years. There are now more non-standard workers than previously: self-employed, part-timers and short-fixed-term workers. Not all these workers present problems for the tax system but some are at the borderline of the employed/self-employed classification. This classification was developed when employment patterns were generally more stable and straightforward.
>
> The increase in all types of non-standard work poses challenges to the legal system of classification. Most people are still in standard work and this may well continue to be the case, but increasing numbers are wholly or partly engaged in variations of this standard pattern. In addition, a high proportion of businesses in the UK are sole traders or partnerships without employees. Many of these will be 'grey area' workers.
>
> In a tax context, this has two main consequences. First, the number of workers at the borderline of the employed and self-employed classification has increased. This puts pressure on the borderline that is drawn in the case law. It increases the problems where very different tax consequences flow from classification. It places a heavy weight on this case law classification and on the courts to make it coherent and as far as possible in tune with reality, whilst maintaining a degree of certainty. The high proportion of self-employment without employees in the business population creates difficulties for a government that wishes to target 'entrepreneurs' or 'genuine businesses' for reliefs and allowances, but to exclude those it perceives to be 'disguised wage-labourers'. …
>
> Second, even where classification is not an issue because a non-standard worker is fairly clearly on one side of the line or the other, the rules developed for standard workers may not fit easily with the increasing number of those who do not follow the standard pattern.[21]

2.2 Initial responses to IR35

By the end of August 1999, the Revenue had received over 1,700 written comments and suggestions to its proposals, and had held two consultative meetings with 38 representative bodies on their potential implications. Most respondents argued that the proposals would have a very damaging impact on the IT sector; the *Financial Times* quoted Peter Bickely from the ICAEW saying, "The specific anti-avoidance measure targeting one-man companies will mainly hit the computer industry … This is difficult to reconcile with the Chancellor's comments on encouraging information technology.'"[22] Some in the industry argued that individuals would emigrate to avoid the new rules:

> Giant Group, which advises 3,500 British IT professionals on financial matters, is one of many industry organisations giving warning that computer specialists will take their skills abroad if the Government presses on with its crackdown on PSCs. It argues

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21 Judith Freedman, *Employed or self-employed? Tax classification of workers and the changing labour market*, Institute for Fiscal Studies, February 2001 ppvi-vii

22 "Move to target consultants 'undermines policy on IT'", *Financial Times*, 11 March 1999

> that many other nations with shortages of IT skills already offer big tax discounts to woo foreign IT professionals. In the Netherlands, foreign IT contractors receive a 35 per cent tax break. Matthew Brown, chief executive of Giant, said: 'We are facing a massive brain drain. Already we've been inundated with responses from individuals who say they'll simply go abroad.'[23]

Other commentators argued that the measures contradicted the Government's efforts to encourage entrepreneurship;[24] as one commentator in the *Financial Times* put it, "do we want a system where everyone is traditionally employed and supervised; or do we want a system that allows diversity, where independent operators can be rewarded and respected for their skills? The proposals … are presented as tax changes, but their influence is primarily in the nature of employment."[25] Writing in the *Financial Times* tax barrister Jonathan Schwarz emphasised the importance of the consultation process:

> [The Inland Revenue's press release] indicates that the proposed changes are only aimed at engagements with "essential characteristics of employment". This, the Inland Revenue says, should only affect those cases where these characteristics are disguised through the use of an intermediary such as a service company or partnership. It does not intend to redefine the boundary between employment and self-employment. Many will wonder why the Inland Revenue feels the need to legislate against disguised arrangements.
>
> The law has historically protected it against sham transactions. Thus, where a taxpayer creates a facade of reality, quite different from the disguised transaction, proper consideration of the reality of the situation will be given. The government proposes to consult interested parties on this and has expressed concern in "minimising any impact of these changes on ordinary business not involved in avoidance". Perhaps during the consultation process, the real path to ensuring that taxpayers pay their fair share will emerge. A fair tax system should tax those working in similar circumstances in a similar way.[26]

The industry lobbied hard against the proposals, and attracted considerable press coverage,[27] thanks, in part, to the foundation of the 'Professional Contractors' Group' by freelance IT consultants. The issue was raised in a series of PQs: for example:

> **Dr. Cable:** To ask the Chancellor of the Exchequer what estimate he has made of (a) annual tax loss as a result of tax avoidance in the area of personnel services covered by IR35 and (b) the value in 1998 of Government contracts with IT and other companies providing personnel services which will be affected by IR 35.
>
> **Dawn Primarolo:** It is always difficult to measure the extent of tax and national insurance contributions (NICs) avoidance. The measures covered by IR35 are forecast to raise £475 million in 2000-01 and £375 million in 2001-02. No information is collected from contractors which allows an assessment to be made of the

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23 "IT experts fear Budget will spark 'brain drain'", *Times*, 5 April 1999
24 for example, "Battle is on to save the entrepreneur culture", *Times*, 24 June 1999
25 "Threat to flexibility", *Financial Times*, 21 July 1999
26 "Proposal a cause for concern", *Financial Times*, 19 March 1999
27 For example, "Freelances use web as weapon", *Financial Times*, 28 July 1999

> number or value of Government contracts awarded to companies involved in tax and NICs avoidance.[28]

It was also discussed during the proceedings of the Finance Bill 1999, when John Whittingdale raised the issue with the then Paymaster General, Dawn Primarolo:

> **Mr. John Whittingdale** : Will the Minister make an immediate statement to allay people's concern about how genuine the consultation is, and to make it clear that the Government will not table new clauses for the Finance Bill, and that any legislation will be delayed until there has been an opportunity for all those affected by the proposals to make representations to the Government and to have them properly taken into account? …
>
> **The Paymaster General (Dawn Primarolo):** My right hon. Friend the Chancellor made it clear in the Budget statement that a full year's notice is being given before we legislate on the matter. The hon. Gentleman will be aware that the Inland Revenue is consulting representative bodies and inviting comments on the proposals in advance of drafting the legislation. I assure him that the Government intend to legislate on the matter in the next Finance Bill. His concern that legislation may be included in the Bill before us is unfounded. We are consulting, and the consultations are real. The outcome will form our judgement in terms of draft legislation … I look forward to discussing the matter in next year's Finance Bill Committee, when I hope properly to allay Opposition Members' fears.[29]

In June 1999 the Tax Faculty of the Institute of Chartered Accountants, the Chartered Institute of Taxation, the Confederation of British Industry and the Law Society submitted a joint letter to the Paymaster General, reproduced below:

> We are writing to express our concern about the very wide scope of the above proposals announced in Budget Day press release IR35 and in subsequent material distributed by the Inland Revenue. They appear to go well beyond what is necessary to counter the sort of avoidance that the Chancellor alluded to at the time of the Budget. The proposals will put significant burdens on business insofar as every single company that provides services will need to register with the Inland Revenue as an 'exempt agency'. Although the details that the Inland Revenue have released to date are very sparse, they also appear to prevent a company from qualifying for exemption if it has shareholder employees and pays dividends. This seems counter to the Government's professed intention to encourage employee shareholdings.
>
> We are also concerned that the test of avoidance goes far beyond the normal definition of employment and will embrace very many genuine businesses. The basic test proposed is whether the client has a right of supervision, direction or control as to either the tasks undertaken or the manner in which they are performed. It is hard to envisage any provision of services where the client does not have a right of direction or control as to the tasks undertaken, as he cannot specify what services he wants performed without having such a right. We are particularly concerned that the courts have consistently held that 'control' is not the only valid test of self-employment; it is merely one of a number of factors that

[28] HC Deb 28 April 1999 c146W
[29] Standing Committee B, 18 May 1999 cc215-217

> need to be weighed up to determine whether or not a person is 'in business on his own account'.
>
> We note that you told the Finance Bill Standing Committee on 18 May that the Government is undertaking genuine consultation on these proposals. However, the letter that we have received from the Inland Revenue suggests that there is to be no consultation on the scope of the legislation, but merely on the guidance to be given to taxpayers and that taxpayers will have an opportunity to point out to the Revenue practical problems that may have been overlooked.
>
> We believe that these proposals will be very damaging to the business sector and to the reduction of unemployment. They will drain companies of cash and discourage retention of profits, which are bound to inhibit growth. As these proposals completely undermine the traditional distinction between employment and self-employment we think it vital that there should be proper consultation, both on the principles and details of these proposals. They represent a fundamental change to the tax system which has implications far beyond the possibility of avoidance.[30]

2.3 The Government's revised proposals

Following speculation in the press during the summer,[31] on 23 September 1999 the Paymaster General announced a number of changes in the proposals for PSCs:

> "Consultation has confirmed that there is a genuine issue of tax avoidance in this area, and there is widespread agreement that we are right to tackle it. I am determined that nobody should be able to avoid paying their fair share of tax and NICs just because of the way they structure their relationship with their clients. But we have always recognised that any action must do no unnecessary damage to the flexible labour markets where intermediaries are currently used.
>
> I have therefore asked the Inland Revenue to publish a number of changes to the proposals they distributed in April 1999. These changes mean that we will still be able to stop this avoidance, from next April, but in a way that is more tightly targeted and does not prevent the use of intermediaries where they provide non-tax advantages."[32]

The main changes to the proposed rules were:

- the rules will rely on the *existing* tests which are currently used to determine the boundary between employment and self-employment for tax and National Insurance Contributions purposes, instead of the alternative test put forward originally. Using these more familiar tests will help understanding of the new rules and ensure they are targeted on the right people.
- the responsibility for ensuring that the new rules are followed will belong to the *intermediaries* themselves, not the clients, as originally proposed. As a result of this approach, there will be no

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30 Institute of Chartered Accounts, *Countering avoidance in the provision of personal services* TAXREP 15/99, 4 June 1999

31 for example, "Tax avoidance crackdown plans to be weakened", *Financial Times*, 9 August 1999

32 Inland Revenue press notice 162/99, 23 September 1999

need for a certification scheme to allow clients to identify intermediaries who could continue to receive gross payments.

- the *intermediaries* will be responsible for applying PAYE and National Insurance Contributions to all earnings from relevant engagements, after a limited allowance for expenses and pension contributions.

The Revenue published a summary of this modified approach; it is reproduced in an appendix to this note.

Generally the response to this announcement was cautiously positive:

> The government has watered down its proposals to stop £450m worth of tax avoidance by contract workers, in the face of an unprecedented internet campaign to prompt a policy rethink. The Professional Contractors Group, which ran the web site campaign, dismissed the concessions as a disaster… But others welcomed the announcement: "Two cheers, I think. Most of our clients will not have to worry about this any more," said John Whiting, of PwC, the big accountancy firm.[33] Peter Falherty of the Association of Technology Staffing Companies welcomed the announcement. "In my opinion it is a very good result for our members," he said.[34]

As this piece noted, the Professional Contractors Group remained critical, both of the consultation process itself, and the revised rules:

> The Professional Contractors Group accused the Government of paying lip service to holding genuine consultation on the IR35 proposals, which will effect tens of thousands of small companies in the UK. The Revenue's revised IR35 proposals published today (September 23) show 'astonishing naivete' of the knowledge-based entrepreneurial sector and tip the balance in favour of large US companies at the cost of small British enterprises.
>
> Andy White, Chairman of the PCG, said: "Inviting people to sit around a table and then tell them what the Revenue intends to do regardless of their opinions is not genuine consultation by anyone's standards. And it's certainly not consultation as spelt out in the Government's own Better Regulation Guidelines. The process has been a sham. There have been poor proposals, ignored letters, false promises and no genuine consultation, Gordon Brown and Dawn Primarolo have repeatedly ignored the people who will be affected by this. Now they have replaced the unworkable with the illogical." … The proposals have replaced the 'direction and control test' with existing tests for self-employment which do not take into account the actual workings of the knowledge-based sector. They also deprive entrepreneurs of the ability to retain profits to grow their businesses and are a body blow to enterprise culture.[35]

The Institute of Directors was also critical, suggesting that although the Government was "right to apply the traditional employment / self-employment test … and to relieve the end-users of services from administrative burdens" the proposals will still result in the Government "taking a lot more money from legitimate businesses" and in "major

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33 Mr Whiting's views were set out in, "IR35 – one and a half cheers", *Tax Journal*, 11 October 1999

34 "Plan to stop tax abuses by contract workers curbed", *Financial Times*, 24 September 1999

35 PCG Press Notice No 12/99, 23 September 1999

administrative difficulties, especially for companies involving more than one person and for partnerships."[36] For their part, the Chartered Institute of Taxation was more supportive:

> "The previous proposals were unworkable and unjust, and would have strangled an important part of the service sector", said Anne Redston, Chairman of the CIOT's Personal Taxes Sub-Committee ... "The new rules are less burdensome and focus on a much smaller target group. We are pleased that Ministers have listened to the representations we and others have made, and cut away much of the red tape in the original proposals."
>
> The CIOT warned however that the new rules, which will come into effect in April 2000, will still create additional burdens on business. The new rules contain traps and penalties for the unwary. There are no exemptions for those who have a personal service company for purely practical reasons - tax avoidance motives are assumed. Anne Redston continued: "Those still affected by the new rules will need to get to grips with some complex areas of tax law. Only those who can prove that they would be self-employed if they were operating as individuals, rather than via a service company, will escape the revised proposals."[37]

The Tax Faculty of the Institute of Chartered Accountants was also positive, with certain reservations:

> Francesca Lagerberg Senior Technical Manager at the Tax Faculty said: 'We are pleased to see that the Inland Revenue has listened to our representations, and those of other bodies and has reverted to the normal distinction between employment and self-employment to determine who should be penalised under the proposed legislation. This is a better test than the original "control" test found in the initial proposals. We are also pleased that the burden of demonstrating these rules has been taken away from clients and given to the intermediary company. This removes the need for a bureaucratic certification scheme.
>
> However … in a modern working environment, it is very hard to make rigid separations between people in employment and those in business on their own account. Although the Revenue will be offering assistance to taxpayers to enable them to determine whether they fall in or outside of the new rules, this help is unlikely to be fully operational before the rules become law next year …
>
> One other factor regarding the policy behind the personal service company proposals is that when the new rules are in place there will be a clear difference in the treatment of those who use service companies and those who are sole traders. Francesca Lagerberg noted: 'We can see no justification for the discrimination between those who are self employed and work as sole traders and those who go into partnership with others or through the medium of a company.'[38]

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[36] IoD press notice, *IR35: only a little progress*, 23 September 1999
[37] CIOT press notice, *Threat of strangulation recedes*, 23 September 1999
[38] ICAEW press notice, *"'Two steps forward, but is it enough?' say chartered accountants*, 24 September 1999

3. Legislation to implement IR35

3.1 National Insurance (1999-2000)

Legislation dealing with National Insurance contributions (NICs) cannot be included in Finance Bills.[39] In May 1999 the Labour Government introduced a new clause to 'tie in' the NI treatment of PSCs at the Report stage of the *Welfare Reform and Pensions Bill*. Following the adoption of this clause,[40] the Bill passed to the House of Lords, where it received a Second Reading on 10 June 1999. The *Explanatory Notes* to the Bill provided a short summary:

> Clause 70 concerns the situation where an individual (the worker) is engaged by a business (the client) through a third party (such as a service company). In the absence of such a third party, the relationship between a client and a worker would determine the employment status for the purposes of both tax and National Insurance. The liability would then be assessed according to whether the person was employed or self-employed. However, where a worker is engaged through one or more third parties that have separate legal identities, it is possible to escape any direct contractual relationship between client and worker. This provides scope for avoiding tax and National Insurance.
>
> The powers in this clause are intended to enable payments made in respect of a worker hired by a client through an intermediary to be treated in the same way as earnings paid to an employee - so long as the underlying relationship between the client and the worker has the characteristics of employment. To achieve this, tests will be applied to examine the substance of the relationship. Where they indicate that the relationship has the characteristics of employment, the new provisions will apply. Payments by the client may then be regarded as earnings paid to the worker for the purposes of primary Class 1 NICs, and the client will be liable for the corresponding secondary NICs, unless the intermediary is a certified agency ...
>
> Matching tax provisions are intended to be included in the Finance Bill 2000 to require the client to operate PAYE on payments made to, or in respect of, the worker …
>
> In order to minimise any administrative burden, the Chancellor announced that the details of the new rules would only be finalised after consultation with representative bodies. The clause has been drawn up so as to allow for NICs regulations to take effect at the same time as the proposed new tax rules (i.e. from 6 April 2000) without recourse to retrospection and without pre-empting the outcome of consultation on issues of detail. The clause sets out the general powers on the face of the Bill and allows for the technical detail to be contained in regulations. This will enable changes to be made more easily if the parallel tax proposals, or business practice, change in the future.[41]

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39 It is a Parliamentary convention that Finance Bills are concerned with moneys that go into the Consolidated Fund – but receipts from NICs go into the National Insurance Fund, and not the Consolidated Fund.

40 This provision was incorporated in clause 70 to the *Welfare Reform and Pensions Bill* as brought from the Commons on 21 May 1999 [HL Bill 62]. Clause 71 made parallel provision for Northern Ireland.

41 HL Bill 62-EN, 21 May 1999 pp147-148

When this clause was debated at the Report stage of the Bill in the Commons,[42] there was criticism that the Government had introduced these provisions prior to consultation, as well as wider concern as to IR35. Introducing the clause Stephen Timms, then Minister of State at the Department for Social Security, made the following comments:

> The new clause will allow the Revenue to draw up tests, set out in regulations, which it can use to examine the relationship between a business and a hired worker. The key element of the test will be the degree of control the employer has over the worker. This uses the control test already successfully used to determine whether an employment agency should be treated as the employer for the purposes of liability to pay class 1 NICs. The question to be asked is: "Has the employer ongoing control over what tasks the worker does or how they are carried out?" If the answer is yes, the arrangement will be caught by the new rules and any earnings will be subject to class 1 contributions ...
>
> The new clause is not intended to remove the benefits that many businesses derive from the use of employment agencies for a supply of labour … Under existing legislation, the agency that supplies the worker, and not the client, is liable for any tax and national insurance payable on the worker's earnings. The worker is regarded as an employee of the agency, which must set up a pay-as-you-earn arrangement and ensure that the necessary class 1 contributions are deducted for any earnings, as well as paying those secondary class 1 contributions as an employer.
>
> We have no wish to reverse that arrangement and the clause will not do so. Indeed, subsection (3) allows exemptions from the provision to deal with that issue. For example, if the worker is regarded for income tax purposes as employed by a "certified" agency, and the services are performed by the worker in the course of that employment, the clause does not bite. A business need seek confirmation only that a worker is supplied from a certified agency to be assured that it is not liable for any tax and national insurance on that worker's earnings. The Inland Revenue will be responsible for running the certification scheme ...
>
> The essence of the certification scheme is that the agency that supplies the worker will take responsibility for setting up pay-as-you-earn arrangements and paying class 1 national insurance contributions for all the workers on its books. As well as established agencies, other providers of labour are likely to wish to seek certification through the new Inland Revenue scheme...
>
> We have not published the regulations yet, but there will be extensive discussion between the Inland Revenue, those who responded to the document and representative organisations …
>
> We need to stop the increasing drain on the national insurance fund by people who disguise the nature of their employment … We have certainly considered the additional revenue that will be gained to the national insurance fund. In the long term, it will run to £216 million a year. The cost to the Inland Revenue of this and of the parallel income tax measure will be £175,000 in the current year and £55,000 a year in the long term.[43]

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42 HC Deb 17 May 1999 cc729-766
43 HC Deb 17 May 1999 cc731-735

The clause was debated in the Lords on 20 July 1999, when it was adopted without amendment.[44] Lord McIntosh of Haringey, speaking for the Government, explained why this provision was needed:

> There are two reasons why the subsection is needed. First, NICs are not as flexible as tax about when a provision comes into force. NICs' liability is geared to a worker's pay period, be it weekly or monthly; any NICs legislation must be introduced prior to the start of the tax year. The Welfare Reform and Pensions Bill allows for such a timetable to be met. But the provision for tax in the Finance Bill next year - 2000 - will not be ready for this timetable. It is therefore important for us to be able to amend the detail of the NICs provisions to take into account any detailed changes in the tax rules. I am sure that Members of the Committee understand the need for business to operate to one set of rules rather than two.
>
> Secondly, the subsection gives flexibility to keep the NICs measures in line with the tax rules. The annual Finance Bill means that changes to the tax legislation can occur every year subject to parliamentary approval, but there is no equivalent annual legislation automatically available for the national insurance legislation. So without the subsection it would be difficult to amend the contributions and benefits Act to mirror any necessary changes in the Finance Bill.[45]

Following the Paymaster General's announcement on 23 September 1999, the Labour Government proposed a series of amendments to these provisions to take account of the new approach. These were put forward at the Report stage of the Bill on 13 October, although in the event, the Government was defeated, and the House accepted two amendments to remove both clauses from the Bill.[46]

On this occasion, Lord McIntosh of Haringey went into considerable detail as to the Revenue's consultation – first on the decision to shift the obligation to apply IR35 from the client to the intermediary…

> There are three main changes to the revised approach. One thing we learned from the consultation was that both clients and workers saw benefits in the use of intermediaries - that is, these one-person companies - to hire skilled staff for short contracts, regardless of the tax and NIC advantages. The original proposals would effectively have given the client a choice between taking the worker onto his payroll for a short period, or running the risk of a PAYE and NIC liability on the contract payment which he had made to the consultant service company. We were told that that threatened to take away the flexibility. We therefore decided to change the proposals so as to give the clients the option of continuing to hire workers through intermediaries on the basis of gross payment and without the risk or a new tax or NIC liability. The obligation to pay a fair share of tax and NICs will still be there, but it will be an obligation on the intermediary, not on the client.
>
> One welcome result of that approach is that there will be no need for the Inland Revenue to run a certification scheme. That was originally proposed to allow clients to identify those service companies which could continue to receive gross payments. Many

44 HL Deb 20 July 1999 cc912-938
45 HL Deb 20 July 1999 c936
46 HL Deb 13 October 1999 cc476-497

> were concerned about the administrative and bureaucratic demands which would result for both workers and clients.

… second on the decision to apply existing tests to determine the boundary between employment and self-employment …

> As the House is aware, our original proposal would have relied on the degree of control that the client had over the worker as to the task and manner in which it was completed to decide whether he should be treated as an employee under the new rules ... That was much criticised during the consultation. Now that we have decided to remove from the client any need to identify the contracts caught by the new rules, we have had the opportunity to look again at the way in which we identify those contracts. We have decided to accept the arguments made in the consultation process and to retain the existing method of determining the boundary between employment and self-employment for tax and national insurance contributions purposes, as it is used for individuals without service companies. That method is based on the courts' interpretation of the concept of employment, without a detailed statutory definition …
>
> It has … been suggested that the definition of employment which is already used throughout the economy - including, for example, in the market research industry, which I know well - is in some way not appropriate for the information technology and engineering industries. I find that idea extraordinary … There are freelance workers in all kinds of industries, not just IT: trainers, draftsmen, writers, cameramen - in fact, 90 per cent of the film production business is made up of self-employed people. Unless they have opted out by setting up service companies, the same definition of employment applies to all of them. I see no justification for arguing that it cannot be applied to the IT industry as it has already been for all the others.

… and third on deductions that intermediaries would be able to apply in assessing the amount of tax to be paid:

> The announcement on 23rd September also included clarification of the amounts which could be deducted from an intermediary's receipts from clients to arrive at the amount on which class 1 NICs and, in due course, PAYE tax would be due. These deductions are: first, any expense which would be allowed to an employee in the same circumstances; secondly, any employer's contributions paid by the intermediary to an approved pension scheme on behalf of the worker; thirdly, any class 1 NICs paid by the intermediary in respect of the worker, plus a flat-rate allowance of 5 per cent of the intermediary's receipts from relevant contracts. That deduction is to recognise the general and miscellaneous expenses associated with running a service company. We believe that the deductions for expenses which we have listed are fair to workers who chose to set up a company to market their skills and those who are employed directly. The effect is to make a choice whether to operate through an intermediary or as a direct employee - a neutral one - in terms of tax and NICs ...
>
> It is the decision of an individual whether one is employed directly by a company or sells one's services to a service company. It is a decision for the worker to take. The Government have a duty only to ensure that, whatever decision is made, one should expect to pay a fair level of tax and NICs. If it is argued, as it has been argued by the IT industry, that that puts them at a disadvantage compared to the large and, in particular, the foreign companies

> which provide consultancy, I can only say that that is based on a misconception. Any company which is other than a one-person service company cannot use the loophole of paying its principal in dividends. That company must pay a payroll and therefore must pay NICs and tax on its earnings from its clients. Therefore, there is a level playing field in that respect.

Lord McIntosh went on to explain the purpose of the Government's amendments to this part of the Bill:

> Clearly, the revised clause must reflect the change to transfer to the intermediary the liability to pay any NICs due under the new rules. That is achieved by changing references from "client" to "intermediary". There are consequential changes which recognise whether it is payments made or deemed to be made to the worker by the intermediary rather than payments by the client on which NICs must be paid. That introduces the concept of attributable earnings; that is, the total earnings from the client less the four items I have already described.
>
> Subsection (2) allows regulations to define an intermediary for the purposes of this provision. It is the service company which employs the worker or a partnership of which he is a partner. Subsection (3)(b) confirms that the intermediary is the secondary contributor. The new subsections on page 76 line 12 provide more detail of some of the deductions which regulations may allow in calculating attributable earnings. They provide the power to set in regulations a deduction for the general expenses in running a service company.
>
> The other main change is the amendment to remove subsection (5) which was the provision that provided for a certification scheme, which is no longer necessary.[47]

Speaking for the Liberal Democrats, Lord Goodhart argued that although the problem of NIC avoidance was a real one, the Government's amended approach should not be pursued with:

> Under the Government's new proposals employer's NICs will be paid, but they will be paid by the personal service company on the receipts from the client and not by the client itself. This, we believe, is wrong. It gives a significant advantage to a client which deals with a personal service company rather than directly with the worker. In borderline cases it plainly shifts the risk of an adverse ruling from the client to the personal service company and, through that company, to the worker himself or herself. There are four main objections to that.
>
> First in most cases it is frankly easier for the client than for the worker to bear the risk of having to pay employer's NICs. That is especially so where the client is a substantial company and may have a number of short-term contract workers across whom it can spread the risk. Secondly, if there is a risk of an uncertainty as to what the status of the worker is, it is plainly easier for the client than for the worker to get legal advice and to form a judgement of the degree of risk. The parties therefore are not, when they enter into contracts with each other, contracting on the basis of equal information and therefore on an equal footing.
>
> Thirdly, it follows that if a dispute arises and has to be fought with the Inland Revenue, it is plainly easier for the client to fight it than for the worker to fight it. Finally, pressure on workers from clients

[47] HL Deb 13 October 1999 cc477-480

> to form personal service companies, even if the worker does not want to do so, which already exists, will continue and may very well increase ...
>
> The Government have to some extent improved their original scheme and it now appears to be acceptable to a number of professional bodies which criticised the original scheme. But we think that the drawbacks for workers … of placing on them the liability for employer's NICs and the risk in cases of uncertainty have been underestimated. We will therefore have to ask the Government, even at this very late stage, to reconsider their proposals.[48]

Speaking for the Conservatives, Lord Higgins echoed Lord Goodhart's criticisms, and in the absence of sufficient time for consultation, the clauses should be reintroduced as part of the Finance Bill:

> If the government amendments are accepted, the Bill will go to another place. But we know only too well that it will be very difficult for those in another place, on seeing these proposals for the first time, to discuss them in detail ...
>
> I think that another place should be given a full opportunity to look into the matter and discuss it … I do not think that it would be overstating the noble Lord's position to say that he has argued that that is really quite impossible because Finance Bills can only be concerned with revenues that go into the Consolidated Fund and not those which go into the National Insurance Fund … It seems to me that that is probably an obsolete approach for the simple reason that at the beginning of the year we agreed a transfer of functions Bill … which transferred responsibility for the Contributions Agency … from the Department of Social Security to the Inland Revenue.[49] Therefore, as this is an Inland Revenue matter lock, stock and barrel, it is absolutely clear that it should be dealt with in a Finance Bill ...
>
> It is normally the practice that the Finance Bill contains only measures of the kind that he has described. But it is also the case … that a resolution can be passed whereby such practice can be over-ridden and appropriately adjusted. If the noble Lord would care to look into the situation in another place on 23rd March 1987, he will find a record of a resolution, which was put before the House and approved; and, indeed, acted on. It related to the procedure under "Personal Pension Schemes", and stated:
>
> "Ordered, That, notwithstanding anything to the contrary in the practice of the House relating to matters which may be included in Finance Bills, any Finance Bill in the present Session may make provision for payment of sums out of or into the National Insurance Fund"-- I repeat, the National Insurance Fund-- "in connection with provisions relating to the payment of minimum contributions under Part I of the Social Security Act 1986".
>
> … My view is that we should not accept these clauses this evening, or the amendments put forward by the Government. It would be more appropriate to delete them from the Bill and for them to be dealt with in another place in the way they should have been dealt with from the start.[50]

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48 HL Deb 13 October 1999 c482

49 The *Social Security Contributions (Transfer of Functions, etc.) Act 1999*. For details see Commons Library Research paper RP99/12, 5 February 1999.

50 HL Deb 13 October 1999 cc484-487

In the event the Labour Government were defeated when the House came to vote on the new clause,[51] though this was overturned when the Bill returned to the Commons on 3 November 1999.[52] On this occasion Treasury Minister, Stephen Timms, set out the Government's case at some length:

> The original proposals were subject to two complaints. The first was that a new burden was being imposed on the client to run PAYE and national insurance for his or her employee; the second was that there was a new and much tighter status test relating to the idea of control … The modified proposals were published on 23 September in an Inland Revenue press release. They will place responsibility for complying with the new rules on the service company rather than the client …
>
> When it has been established that the new legislation applies to a worker, that person will be obliged to pay PAYE tax and class 1 national insurance on a minimum salary from the service company. The minimum salary is calculated by taking the money received by the service company from the client for the relevant job and deducting amounts for expenses paid by the company. Those deductions are any expenses that an employee in the same circumstances would be entitled to claim as deductions for tax purposes … Other deductions include any employer's contributions paid by the intermediary to an approved pension scheme on behalf of the worker, any secondary class 1 national insurance contributions paid by the intermediary in respect of the worker, plus a flat-rate allowance of 5 per cent. of the intermediary's receipts from relevant contracts. That deduction is to recognise the general and miscellaneous expenses associated with running a service company …
>
> The rules that apply to everyone else, including people in the IT and engineering industries who do not work through service companies, are appropriate for IT consultants as well. Many IT consultants will be able to demonstrate that they would qualify to be treated as self-employed under the ordinary definition and therefore would not be affected by the legislation, but someone who works for a long period for a single client, sitting at a desk in the client's office, as part of a team consisting of a mixture of contractors and permanent employees, all doing identical jobs, should pay the same tax and national insurance as those permanent employees …
>
> It has been argued that the proposals would favour big foreign firms over small United Kingdom businesses, but that is not true. Our proposals will prevent a form of avoidance that is only available to workers who control their own service companies and can use them to decide the form in which they take their income to minimise tax and national insurance … It is not an issue for big companies that cannot be used by employees to manipulate the form of their income. Where there is evidence of tax avoidance by large companies, we are just as ready … to act against that.
>
> The real competition that we should be concerned about is that between people who are employees and others doing substantially the same job, but using a service company to pay much less in tax and national insurance. That is unfair and we shall stop it … There has been a well-funded campaign by a special interest group that is seeking to preserve its right to avoid

[51] The House voted by 84 to 66 votes to leave out these clauses from the Bill.
[52] HC Deb 3 November 1999 cc404-441 By 345 votes to 203.

> tax--make hay while the sun shines. We are not going to back down; we owe it to the millions of taxpayers and contributors who are paying their fair share and who have to bear the burden when other people do not do so. I ask the House to support them, the motion and the Government amendments.[53]

In turn the Lords accepted the Commons' amendments on 8 November.[54] This legislation was consolidated in section 75 of the *Welfare Reform and Pensions Act 1999* (section 76 made parallel provision for Northern Ireland). Finally, on 13 March 2000 regulations were laid before the House under this provision, to come into force on 6 April 2000 (SI 2000/727 & SI 2000/728).

3.2 Income tax (Finance Act 2000)

Although Gordon Brown, who was then Chancellor, did not discuss IR35 in his Budget speech on 21 March 2000, the Budget report mentioned it briefly:

> **5.116** Tax-driven schemes, devices and structures, if allowed to flourish unchecked, not only cause ordinary taxpayers to have to make good the resultant loss of revenue but can also give one business an unfair competitive advantage over another. They can also undermine the credibility of the tax system generally. Budget 2000 shows the Government's continuing commitment to protect the revenue base by tackling avoidance across the whole tax system. Among the measures in the Budget [is] … legislation to give effect to the proposals already announced to stop avoidance workers who would otherwise be treated as employees of their clients.[55]

Provision with regard to IR35 was made by clause 59 and Schedule 12 of the *Finance Bill 2000*. Clause 59 was one of the clauses selected for debate by the Committee of the Whole House, on 3 May 2000.[56] On this occasion, Richard Ottaway set out the Opposition's position as follows:

> The self-employed work through intermediaries not, as the Government would have us believe, to avoid national insurance contributions, but primarily because it is the most sensible way to arrange their affairs. It helps with the establishment of offices at home, with the purchase of specialised equipment to carry out their job and with travel and accommodation expenses. The Government, with a complete lack of vision, accuse such people as though they were somehow cheating the public. The very opposite is true. Contractors do not get such a good deal; they often do not receive such good benefits as the employed personnel with whom they work … The legislation is muddled. The measure breaches Labour's manifesto commitments, it is a bureaucratic nightmare, it erodes Britain's competitiveness, it will lead to a brain drain and it will not raise the revenue that the Government hopes for. The Government should delay

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53 HC Deb 3 November 1999 cc407-410
54 HL Deb 8 November 1999 cc1215-1230
55 *Budget 2000* , HC346, March 2000 pp103-104
56 HC Deb 3 May 2000 cc183-220

> implementation to give them time to reconsider the damage they are causing. That is why we shall vote against the clause tonight.[57]

Edward Davey of the Liberal Democrats also spoke against the clause:

> We shall vote against the provision because it is extremely pernicious and damaging to British industry's long-term wealth creating sector--the e-commerce sector … If we are to oppose the proposal constructively, we must debate how we would tackle the abuse that we agree has occurred--the "Friday evening, Monday morning" abuse … The Liberal Democrats believe that that abuse could be tackled without hitting the legitimate contractor. One could consider past contractual relationships between employees of a personal service company and its main or sole clients; we could target that abuse and hone in on it to stop it. That is the approach that we recommend, but not the one in the schedule that the clause will implement.[58]

The then Paymaster General, Dawn Primarolo, summarised the Government's position in responding to the debate:

> The tax system has a long-established method for distinguishing between employees and the self-employed entrepreneur. Some people have chosen to use service companies because they do not fit the definition of self-employment, but still want to benefit from the tax breaks available for self-employment. They are really only employees who want a better deal from the tax system than that to which their status entitles them. Those people will be targeted by the new rules ...
>
> The idea that people who are really employees are the same as self-employed people in taking risks, creating employment and seeing their companies grow simply does not stand scrutiny. We are not talking about all service companies or all IT contractors. The new rules will apply to people in service companies who would be employees of their clients if the service company did not exist. The usual case law tests will be used to determine whether someone would be an employee. Those tests have been used by all others in the tax system and are well known. I do not believe that it is beyond the intellectual capability of those IT consultants who are still protesting to get to grips with these rules.[59]

Schedule 12 was the subject of a long debate in Standing Committee, though it was passed unamended.[60] During this debate the Paymaster General made a number of observations on the scale of this practice…

> There are 90,000 individuals working through service companies. Their average annual earnings are £50,000 and they pay, on average, 21 per cent. in tax and national insurance ... If we compare that with someone in an identical employment relationship in terms of where the work is carried out, how it is carried out and who supervises it but who is an employee, that person pays 35 per cent. tax and national insurance through pay-as-you-earn. The only difference between the two workers is the interposing of a service company, which adds nothing and does not change the terms and conditions or the nature of the work. The vast majority work on standard contract terms that clearly represent employment …

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57 *op.cit.* cc184, cc190-191
58 *op.cit.* cc191-192
59 *op.cit.* c214. In the event the House voted in favour of the clause by 252 votes to 147.
60 Standing Committee H, 6 June 2000 cc426-487

… and the work the Revenue had done to help those seeking to determine if they were covered by the new rules:

> So far, the Inland Revenue has been asked to examine 1,200 contracts to ascertain whether they involve employees or self-employed people. That is a reasonable sample. Of that sample, 53 per cent. were found to be within IR35, and 47 per cent. were found not to be within IR35, and would therefore not be caught by the current employment tests that work throughout the tax system.[61]

Although many Members continued to receive representation by constituents on IR35,[62] this marked the end of its debate in the House. The issue was not raised during the Report stage on 18-19 July, and the Bill completed all its remaining stages in the House of Lords on 28 July – receiving Royal Assent that same day.[63] The new rules took effect from the beginning of the tax year: 6 April 2000.

Prior to the 2000 Budget, the Government had confirmed that these provisions would become law once the Finance Bill received Royal Assent, and be applied retrospectively.[64] In February 2000 the Inland Revenue had issued detailed guidance on the application of the law, to show how current contracts would be affected when the new rules took effect – and further guidance for those affected by the new rules followed this.[65]

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61 Standing Committee H 6 June 2000 c449

62 for example, "Business in plea over tax rules for IT consultants", *Financial Times*, 7 July 2000

63 It is worth underlining the Lords do not have the authority to amend any provisions in the annual Finance Bill. Following Royal Assent, these provisions formed section 60 & schedule 12 of the *Finance Act 2000*.

64 HC Deb 22 February 2000 cc983-984W

65 Inland Revenue press notice 14/00, 7 February 2000. This was published in the February 2000 issue of the Revenue's *Tax Bulletin* (issue 45 pp715-723). There is an archive page of the material HMRC published on IR35 here.

4. Subsequent developments

4.1 Judicial review (2000-2003)

On 10 October 2000 the Professional Contractors Group was granted leave by the High Court to proceed with a judicial review to examine if IR35 was is in breach of the Human Rights Act and European laws.[66] A commentary on the Group's case was published in the *Financial Times* at this time; part of this is reproduced below:

> The dispute between the Treasury and the industry centres upon differing interpretations of a well-documented employment trend. This is the tendency of big companies - and indeed government departments - to contract out IT projects. The consultant brought in will often spend a period of many months doing the work. The Inland Revenue says many of these people are de facto employees. They are under the direction and control of the company they are working for, which provides them with the equipment and support they need. In other words, they are in the same position as permanent employees and yet they pay altogether less tax.
>
> The consultants say it is a travesty to portray them in this light. They pay less tax and national insurance because they are not entitled to employee benefits such as sick pay and holiday pay. They have a less secure existence than ordinary employees and need the extra money to fund them in the blank periods between contracts. The consultants say they face further problems because IR35 has stopped them claiming tax allowances on investments in their businesses …
>
> Gareth Williams, PCG chairman … says the Revenue's actions are precipitating an exodus … The problem is that evidence of mass departures is almost non-existent … One industry observer says IT specialists often do projects overseas. He sees no sign of a rise in those going abroad. "The only evidence I have seen is anecdotal," says John Charlton, the editor of Freelance Informer, a fortnightly magazine for IT contractors. "The odd letter - I hate Tony Blair, I am going, that kind of thing." It is an indication of the work the industry has to do to make its case.[67]

At Treasury Questions on 29 March 2001, Graham Brady MP asked the Paymaster General whether she was "not ashamed of having introduced a tax that will drive skilled information technology professionals overseas." The Minister's response on this occasion is instructive, and is reproduced below:

> The legislation is fair, proportionate and compatible with the United Kingdom's obligations under EU legislation. There is no evidence to support the allegation that a flood of IT specialists are leaving the UK. The hon. Gentleman should look at some of the various publications; for example, an article called "Contractor UK" by David Houston of Glow International Ltd. He warns IT specialists that despite the widespread press speculation concentrating on UK contractors post-IR35, it is a fallacy that they would be better off overseas. He reminds them that in western

66 "IT group wins review of tax law", *Financial Times*, 11 October 2000
67 "Tax and IT outrage", 12 October 2000

> European countries where there are vacancies for freelance professionals, in every case taxation is higher than in the UK.
>
> The hon. Gentleman's allegation that thousands are leaving is not the case, and his suggestion that the tax proposals are unfair is not the case. He should bear in mind that the measure is to deal with an avoidance mechanism in the tax system whereby those working through personal services companies were paying tax and national insurance at the rate of 21 per cent., whereas an employee earning the same amount in the same circumstances was paying, on average, 35 per cent.[68]

The judicial review took place over 5 days between 13 to 20 March 2001, and on 2 April the Court decided in favour of the Revenue on all counts.[69] In dismissing the PCG's case, Mr Justice Burton found only limited evidence that consultants had left the UK to avoid IR35:

> The PCG … has said IR35 makes Britain uncompetitive compared with some European rivals, arguing that this is driving consultants abroad. It must now back those claims. Mr Justice Burton's judgement offered no encouragement. He makes a "limited finding" that some consultants "may not continue to operate in the UK as a result of IR35". The PCG has asked those who are leaving to register on its website: between August 18 2000 and April 2 this year, only 395 people logged on. The judge approached the question of international competitiveness with similar caution. He drew no conclusion about whether other European countries were more attractive in tax terms. He said he was "just persuaded" IR35 could be an impediment of mobility to consultants in the sense that a positive incentive for them to come or to stay may have been removed.[70]

Mr Justice Burton criticised the Government's initial approach to announcing IR35 and suggested that the Revenue should improve its published guidance material.[71] The PCG appealed against this decision but in December 2001 the Court of Appeal upheld the High Court's judgement.[72] Following this in March 2003 the High Court heard the first individual case on IR35[73] – ruling, again, for the Revenue.[74]

4.2 Further legislative changes

Although the Labour Government showed no interest in withdrawing IR35, it made two sets of changes to the rules in the next two years. In March 2002 it announced three minor amendments to IR35 to, among other things, provide service company workers with the same relief that

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68 HC Deb 29 March 2001 c 1095

69 "Judge rejects IT consultants' tax plea", *Financial Times*, 3 April 2001 & "Law report: IR35 does not breach Convention or EU law", *Times*, 5 April 2001

70 "IT consultants in the dock", *Financial Times*, 5 April 2001

71 At this time the Paymaster General confirmed that the Revenue would "review the guidance material used by its staff regarding the interpretation of the law" (HC Deb 5 April 2001 c239W). Changes to the Revenue's Employment Status Manual were made in May 2002 (PCG press notice, 15 May 2002)

72 "Law report: tax-avoidance legislation does not contravene EC law", *Times*, 14 January 2002. The text of both decisions is on HMRC's archive site.

73 Synaptek Ltd v Graeme Young (HMIT) [2003]. For details see, "Landmark challenge against IR35 tax rule started", *Financial Times*, 28 February 2003

74 "Blow to freelance consultants as tax rule case defeated", *Financial Times*, 29 March 2003. see also, "Law report: consultant deemed employed", *Times*, 7 April 2003.

conventional employees receive under the mileage allowance scheme for business travel.[75]

Second, in the 2003 Budget the Government announced that the scope of IR35 would be extended to cover domestic workers, such as nannies or butlers, who provided their services through an intermediary.[76] Initially it had been the Government's view that nannies and butlers would have little interest in setting up PSCs. However the cost savings of this type of arrangement had led to many parents insisting that nannies to provide their services in this way – arguably at the expense of their employee's best interests. When this measure was debated at the Committee stage of the Finance Bill, the then Paymaster General, Dawn Primarolo, explained that many nannies had been offered schemes to set up PSCs:

> Generally, schemes operate by setting up the domestic worker as a director and shareholder of a personal service company. The individual employee therefore starts off as an employee of the client. Subsequently—not because it improves the employer-employee relationship or because the employer is interested in helping self-employment grow—the positioning of an intermediary is used simply to reduce tax … The domestic company is set up for the domestic worker so that the domestic worker is a director and shareholder of the personal service company. The service company offers the services of the director to the former employer. The domestic worker takes a salary from the company at around the personal threshold of £4,615, and the remainder in dividends. Therefore, if the company net profits are below the threshold for the starting rate of £10,000, the domestic worker can extract up to £14,615 free of tax and national insurance contributions …
>
> The scheme providers usually charge a monthly fee for operating the scheme. Effectively, the domestic worker still receives a weekly or monthly payment, albeit that it might be a larger amount because of the savings that the scheme produces through avoidance—the savings might be split between the former employer and the domestic worker, or the former employer might take all the benefit …
>
> Bearing in mind the tax and national insurance savings, the Government were faced with a significant problem. For example, a letter was circulated to every client of a particular agency that runs the arrangements for nannies. The letter states: "As you will see, we do not believe that the use of a personal service company represents best practice in nanny employment because they involve the use of a tax-saving vehicle which obscures the real employer/employee nature of the relationship between parents and their nannies, with some attendant loss of employment rights for the nannies" …
>
> When the measure was announced and comments were made about the Budget, on Saturday 12 April The Daily Telegraph reported the managing director of Nannytax as saying: "We cover all types of domestic workers—housekeepers, gardeners, butlers,

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75 Inland Revenue press notice, 15 March 2002. Provision was made under section 38 of the *Finance Act 2002*. This was debated at the Committee stage of the Bill that year: SC Deb (F), 16 May 2002 cc134-8.

76 Inland Revenue Budget press notice REV BN9, 9 April 2003. Provision was made under section 136 of the *Finance Act 2003*.

> as well as nannies. The decision to close the tax-break loophole was appropriate. We think the relationship between, for example a family and a nanny, should be one of employer and employee. Nannies who were employed as a private company were losing employment benefits such as maternity leave and some pension rights." … The clause is not about self-employment. It relates to employees and the problems created by a mechanism that is driving them into a relationship that leads to a diminution of their rights and a loss of tax revenue.[77]

In 2007 the Labour Government introduced legislation to prevent tax avoidance from the use of managed service companies (MSCs). This is a corporate form similar to PSCs, though the worker whose services are sold through the company has no control over its business. In just the same way as PSCs, workers have used this corporate form so as to take remuneration in the form of dividends, rather than salary, to avoid tax. The Revenue had found considerable difficulties in using the IR35 rules to apply to MSCs, leading to the introduction of new rules in the *Finance Act 2007*.[78] In addition there continued to be individual cases heard by the Courts.[79]

One related issue at this time was the incidence of 'income shifting' and the Labour Government's plans to introduce legislation to prevent family businesses exploiting the corporate envelope to avoid tax. This technique involves the main earner in a couple diverting part of their income through the business to their spouse, to take advantage of the fact that their spouse is in a lower-income bracket.[80] These plans proved controversial and in December 2008 the Labour Government said it would defer any action in this area. Some commentators argued that, at root, these issues had a common cause: that the tax treatment of small businesses distorted individual decisions on the legal form of a person's business – and these initiatives were no substitute for a full review of the principles of small business taxation.[81]

4.3 IR35's 10 year anniversary

As IR35's ten year approached many commentators argued that the Government should consider a root and branch review of the tax treatment of both self-employment and incorporation. Writing in *Taxation* one practitioner suggested that the IR35 rules "were always just a sticking plaster":

> There appears no end to the constant flow of cases, which suggests that the rules still lack that crucial clarity. The revenue-raising element behind the introduction of IR35 has not been evidenced and the administrative burden of the rules remains. This all points to an issue that was raised many times back in 1999 – these rules were always just a sticking plaster over more fundamental issues to do with the way small businesses and the self-employed are taxed. If we are ever to tackle this area

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77 HC Deb 14 May 2003 cc343-5

78 For more details see, *Managed Service Companies*, Commons Briefing Paper CBP4301, 13 June 2018.

79 "Tax investigations update", *Tax Journal*, 23 February 2008; "Dragonfly crashes to earth", *Taxation*, 2 October 2008; "An unexpected victory", *Taxation*, 10 June 2010

80 see, *Income shifting*, Commons Briefing paper CBP4620, 2 February 2009

81 see, Treasury Committee, *The Budget 2008*, 7 April 2008, HC 430, para 93-7

> effectively we need a Government which wholeheartedly commits to a full review of taxation in this area.[82]

In a paper published by the Institute for Fiscal Studies in 2008, as part of the 'Mirrlees review' of the UK tax system, Claire Crawford & Judith Freedman argued, "the UK experience lends strong support to the argument that the tax system should not seek to favour one legal form over the other. Where the tax system does favour one form, structural solutions (such as rate changes) need to be sought for creating parity, rather than provisions which rely on definitions of sub-categories of businesses which will be difficult to apply and enforce."[83]

Although the Labour Government continued to receive a considerable amount of correspondence "expressing a range of views on this policy",[84] it maintained the view that IR35 was "necessary to ensure fair taxation of everyone who meets the accepted definition of an employee, whether or not they choose to use a personal service company" and not proposed any major changes to the rules.[85] As the economic recession took hold in late 2008 many stakeholders reiterated the case for IR35 to be scrapped.[86]

When IR35 was first announced, it was estimated it would raise £475m in 2000-01, falling to £375m in 2001-02.[87] When asked in June 2005 whether IR35 had been cost-effective, the then Financial Secretary, John Healey stated that it was "not possible to isolate the increase in yield to the Exchequer arising from this legislation alone" because "no data is held on administration and employment costs relating solely to this legislation as it is policed as part of HMRC's general employer compliance activity."[88] A second written answer given in May 2009 made much the same point:

> **Mr. Philip Hammond:** To ask the Chancellor of the Exchequer what estimate he has made of the revenue which has accrued to the Exchequer directly attributable to the introduction of IR35 measures.
>
> **Angela Eagle:** The revenue resulting from the intermediaries legislation (also known as IR35) arises from a number of elements: voluntary compliance with the legislation; the deterrent effect where those who might otherwise disguise employment income through incorporation decide not to; and HMRC compliance activity. HMRC do not routinely collect data in respect of specific types of employers from PAYE returns and it is not possible to measure the deterrent effects. It is therefore not possible to estimate the total revenue accrued to the Exchequer as a result of this legislation.[89]

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82 "IR35 ten years on", *Tax Journal*, 2 March 2009

83 *Small business taxation: a special study of the structural issues surrounding the taxation of business profits of owner managed firms*, April 2008 p28. The authors contributed a chapter to the Review's 2010 overview, and the issue was discussed in the Review's final report published the next year (see Chapter 19).

84 HC Deb 17 July 2000 c97W

85 HC Deb 1 November 2000 cc514-5W. see also, HC Deb 28 November 2000 c588W; HC Deb 12 November 2001 c537W; HL Deb 14 February 2006 cc167-8WA.

86 for example, "News: unloved and unappreciated", *Taxation*, 13 November 2008

87 *Budget 99*, HC 298 March 1999 p112

88 HC Deb 21 June 2005 cc 931-932W

89 HC Deb 5 May 2009 c64W

At this time the Professional Contractors Group announced that, following an FOI request, HMRC had provided it with figures showing that IR35 had "directly raised just £9.2m … between tax years 2002/03 and 2007/08", supporting, in its view, the case for abolition.[90]

On its 10th anniversary, Lorely Burt put down an EDM, which argued that "there is no evidence that IR35 is raising any money for the Exchequer", and that "in light of the current economic difficulties" the Treasury should "abolish IR35 at the earliest opportunity." In the event 121 Members signed this motion.[91]

However, at Treasury Questions on 14 July Treasury Minister Stephen Timms stoutly defended the value of this legislation, arguing that "it remains important that people with personal service companies should not gain an unfair tax advantage over direct employees." Ann Winterton MP, who had raised the issue on this occasion, asked "why punish genuine freelancers when enterprises are needed to generate wealth for the United Kingdom economy, and when there is no evidence that IR35 raises any money for the Exchequer?" Mr Timms replied:

> I would turn the question back on the hon. Lady. Why should somebody who is effectively in an employment relationship with an employer, but with a personal service company, have a tax advantage over a direct employee?
>
> I vividly remember the heated debate after IR35 was announced more or less exactly 10 years ago, but it has operated satisfactorily since then. The key point is that people who are in employment should be taxed as employees. IR35 has therefore addressed a potential unfairness.[92]

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90 Professional Contractors Group press notice, *PCG exposes the truth of IR35's pitiful tax take*, 21 May 2009

91 EDM 1124 of 2008-09, *IR35*, 18 March 2009

92 HC Deb 14 July 2009 cc142-3

5. Appendix: Inland Revenue summary of PSC rules – September 1999

Summary of Modified Approach

The purpose of the proposed new rules remains to remove opportunities for the avoidance of tax and Class 1 National Insurance Contributions (NICs) by the use of intermediaries, such as service companies or partnerships, in circumstances where an individual worker would otherwise be an employee of the client or the income would be income from an office held by the worker.

The rules are not intended to prevent workers from providing their services through intermediaries. However, they will help to discourage the practice of routing engagements through intermediaries simply in order to take advantage of a tax and NICs regime which may be more favourable than that which would apply if the worker were to be taken on as a direct employee of the client.

Identifying engagements where the new rules will apply

It is proposed that the new rules will:

- apply to engagements ('relevant engagements') where:
    - a worker provides services under a contract between a client and an intermediary; and
    - but for the presence of the intermediary, the income arising would have been treated as coming from an office or employment held by the worker under the existing rules used to determine the boundary between employment and self-employment income for tax/NICs purposes, if the individual had contracted directly with the client.

Guidance on the existing rules is included in Inland Revenue leaflet IR56 (available on the Internet at www.inlandrevenue.gov.uk). The rules will be applied in respect of each engagement, in the same way as they apply to individuals who operate without intermediaries.

- not apply to such engagements where :
    - the client is an individual and not in business (so services for a householder should not be affected); or
    - the worker only receives income from the intermediary in a form which falls within Schedule E/Class 1 (e.g. straightforward employees of consultancy firms) and has no other rights to income or capital from the intermediary. Exceptions will be made for income from certain investments (e.g. holdings of small numbers of shares in the employing company). Similar rules are under consideration to exempt partners in larger partnerships.

Tax and NICs treatment where the new rules apply

Under the modified approach intermediaries, and not clients, will be responsible for operating the legislation. It will not be necessary for clients to check whether the legislation applies when they enter into a contract with an intermediary, or to conduct new checks on the status of the intermediary. There will be no certification scheme. The intention is that all the money received by the intermediary in respect of a relevant engagement, minus certain deductions listed below, should be treated as paid to the worker in a form subject to Schedule E tax and Class 1 NICs.

The intermediary

(a) Intermediaries who are companies

Where a company intermediary receives income in respect of a relevant engagement, then :

1. the intermediary will operate PAYE and pay NICs on payments of salary to the worker during the year, in the normal way.
2. If, at the end of a tax year, the total of the worker's employment income from the intermediary, including benefits in kind, amounts to less than the intermediary's income from all that worker's relevant engagements, then the difference (net of allowable expenses described below) will be deemed to have been paid to the worker as salary on 5 April, and Schedule E tax/NICs will be due.
3. Where salary is deemed in this way:
    - appropriate deductions will be allowed in arriving at Corporation Tax profits; and
    - no further tax/NICs will be due if the worker subsequently withdraws the money from the company.

(b) Where the intermediary is a partnership

Where a partnership receives gross payment under a relevant contract:

1. Income of the partnership from all relevant engagements in the year (net of allowable expenses described below) will be deemed to have been paid to the worker on 5 April as salary from a deemed employment held by the worker, and Schedule E tax /NICs will be due accordingly.
2. Any amount deemed to be income within Schedule E/Class 1 under (i) above will not be included when computing the worker's share of Schedule D partnership profits.

However, the Inland Revenue's current practice of including small amounts of Schedule E income in the calculation of Schedule D profits for the self-employed, including partners, will apply also in these cases.

Expenses

It is proposed that an intermediary should be allowed to deduct the following expenses from payments in respect of a relevant engagement in calculating whether any deemed payment is required:

1. all expenses otherwise eligible for deduction under the normal Schedule E expenses rule (S198 ICTA 1988): ie qualifying travelling expenses and

those expended wholly, exclusively and necessarily in the performance of the duties of the employment (guidance on the expenses rules is included in Inland Revenue booklets 480 and 490 (available on the Internet at www.inlandrevenue.gov.uk)) ; plus

2. any employer pension contributions made to an approved scheme which are allowable under normal rules; plus
3. a further flat rate 5% of the gross payment for the relevant contract to cover other miscellaneous expenses, such as running costs of the intermediary;
4. the amount of employer's NICs paid during the year, plus any due on the deemed payment.

Failure cases

Where an intermediary fails to deduct and account for PAYE/NICs on payments to the worker under the new rules, the normal penalty provisions for employer failures will apply. If the intermediary does not meet its obligations to account for PAYE/NICs then the amount may be collected from the worker - as happens in certain circumstances under existing PAYE and NIC legislation.

Inland Revenue, September 1999

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