

# IR35 Solutions

## Review of the current legislation and future options

### ContractorCalculator White Paper

- The UK tax system fails 21st Century work patterns
- IR35 is unfair and unworkable in its current form
- Further 'sticking plasters' are not the solution
- IR35 is likely to remain in place for the medium term
- Flexible workers require certainty in their tax affairs
- The only way to 'fix' IR35 is to make it irrelevant



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Foreword by

# Dave Chaplin, ContractorCalculator

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HMRC's tests of employment have clearly not evolved at the same pace as the flexible, highly skilled, knowledge-based workforce

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A more rigorously policed IR35 is here to stay – at least for the medium term. In the longer term, the only way to 'fix' IR35 is to make it irrelevant.

That's according to the overwhelming evidence gathered as part of the considerable research and analysis ContractorCalculator has undertaken to create this IR35 Solutions white paper. Also unavoidable is the conclusion that a realistic IR35 replacement is nothing more than a pipe dream, as other fundamental tax legislation would have to change to give an IR35 successor the slightest chance of being workable.

The only real hope there is of cleaning up the IR35 mess, and avoiding a replacement that could make matters worse for contractors, is for far more profound taxation issues to be addressed, which would render IR35 redundant.

IR35 was created as a 'sticking plaster' to deal with workers reducing their tax liabilities simply by choosing an alternative trading vehicle, such as a limited company or partnership. The former Labour government rightly identified that such people were costing the Exchequer revenue, but it then badly mishandled the introduction of IR35. Inappropriate tests of employment based on hugely complex employment law has since been applied to catch 'disguised employees'.

The results have been devastating for true contractors. But there should be no doubt that IR35 has been successful in raising considerable sums for HMRC, mainly through the creation of the umbrella company sector and the PAYE tax collected from contractors classed as employees of their umbrellas.

Not only has HMRC's track record of successfully prosecuting contractors under IR35 rules been dismal, but in attempting to apply employment law to contractors, it has become apparent that the concept of 'disguised employment' is absurd. This is particularly obvious when we see that HMRC's tests of employment have clearly not evolved at the same pace as the flexible, highly skilled, knowledge-based workforce.

People work and get paid by those they work for. Some people, by virtue of the sort of contracts they have, their job description and rights and perks, are labelled as employees. Others choose not to be. Yet contractors and employees often perform the same tasks. Typically, an employee has skills learnt by long association with their employer. Equally, contractors bring skills to an organisation that its employees do not have.

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I now sincerely hope that IR35 is not changed or replaced – we don't need any more sticking plasters, just greater clarity and guidance

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Thankfully, there is now a general consensus that after a decade of IR35's corrosive effects, it needs to be ditched and/or replaced. However the only way to 'fix' IR35 is to make it irrelevant by addressing the deeper taxation issue of taxing all workers the same regardless of how that income is earned and which trading vehicle is used. The argument that contractors should pay less tax than employees because of the greater risks they take is increasingly difficult to justify, particularly as contractors typically earn more, often much more, than employees and are rarely at risk of non-payment.

The results of our analysis suggest the conclusions that:

- In the short and medium term, IR35 should be better enforced until
- In the longer term the fundamental issue of taxation on income is addressed by a wider review of taxation.

Is this realistic? Well, yes, this or something very similar may well come to pass.

I now sincerely hope that IR35 is not changed or replaced – we don't need any more sticking plasters, just greater clarity and guidance. I suspect HMRC will make a commitment to enforce IR35 more effectively, and use the huge information assets and expertise at its disposal to create a dedicated and expert taskforce to ensure consistency and target those contractors who are clearly not in business and avoiding tax.

I can already hear the howls of protest, and agree that this would mean a greater number of contractors being caught by IR35 and having to pay more tax in the medium term. But that will encourage far more contractors to adopt a professional attitude to IR35 risk than is currently the case. And it would result in a less combative and more collaborative relationship with HMRC.

Ideally, we'll move the contracting market towards some form of external audit model. That would be ironic, as that was the original model proposed by HMRC in its initial discussion documents in 1999.

Longer term, we can all dream of a fairer and simpler system of taxation, but whether this will ever come to pass is far from certain, despite the best efforts of OTS. The wait for the day that IR35 finally becomes redundant through a restructuring of the UK's tax system may be very long indeed.

# A brief history of IR35

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There is arguably no other single event which has had so much impact on the contracting sector as the introduction of IR35. It has resulted in ten years of uncertainty, pain, financial loss and even lost livelihoods for some contractors.

However, it has brought benefits, too, because over the past decade we have seen one of the most vibrant and vital sectors of the knowledge economy begin to unite and share a common sense of purpose and identity. Through various organisations, the contracting sector has come together both to defend itself against unfair elements of the UK's tax regime and to demand due recognition for the contribution it makes to maintaining UK PLC's position as one of the most competitive global economies.

## So where did it all begin?

It all started one early spring day back in March 1999, with an innocuous press release buried amongst the welter of mass communiqués being distributed to an expectant and hopeful populace as the New Labour administration was coming to the end of its post-1997 election honeymoon period.

The now somewhat infamous 'Inland Revenue 35' press release announced that the forthcoming finance bill would introduce changes 'to counter avoidance in the area of personal service provision'.

The then Chancellor Gordon Brown was determined that contractors would pay their 'fair share' of tax. He specifically wanted to target those contractors who could leave work as an employee on a Friday, only to return the following Monday to do exactly the same job as a consultant paying substantially reduced tax and national insurance.

Actually, most contractors of the day did not have a problem with the concept of paying a fair amount of tax, particularly because they were typically higher earners and therefore already some of the highest taxpayers in the land.

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## One size fits all

However, the proposed new tax laws were designed in such a way as to not only force 'disguised employees' to pay taxes, but also to include and penalise the huge number of legitimate contractors, freelancers, interims and consultants who comprise the UK's world-leading knowledge economy.

And to make matters worse, the proposals from the Treasury showed that the government was not prepared to consult with those affected in any meaningful fashion. This has set the tone of much IR35-related legislation over the past 10 years, with the previous Labour government, HM Treasury and HMRC regularly making changes and moving goalposts, with little or no meaningful consultation.

So, back to 1999. Following a short consultation and a spirited first battle by the newly formed Professional Contractors Group [now known simply as PCG], some 'window dressing' amendments were made to what became law as the **Finance Act 2000 Schedule 12 Provision of services through an intermediary**. This is more typically referred to as the 'intermediaries legislation' or, more simply 'IR35'.

# Determining the objectives of IR35's potential replacements

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## The original rules proposed by the Inland Revenue were clear, unambiguous and well reasoned

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When we examine the objectives of IR35 as they were originally envisioned in 1999, it becomes apparent that they have become progressively diluted to the extent that, even though it remains active on the statute book, the purpose of IR35 is no longer clear. So, as a starting point, the objectives of any replacement to IR35 must be clearly stated and understood to avoid falling into the same trap of unintended consequences.

Indeed, the unintended consequences of IR35 have grown to the extent that contractors could be forgiven for mistaking the original intention of IR35 as being a deliberate attack on the livelihoods of flexible workers. Depending on your point of view when it was introduced in March 1999, it could be seen as a 'greed-tax' to redistribute wealth, or a mechanism whereby all workers contributed their fair share of tax.

The official line from the then Inland Revenue in March 1999 was that IR35 was an attempt to crack down on perceived tax avoidance by disguised employees. In particular, it was targeted at those leaving employment on Friday to start contracting for their previous employer on Monday, and doing exactly the same work, in the same circumstances, but contributing considerably less through taxations.

The footnotes on the Inland Revenue's discussion documents from early 1999 show that the new measures were intended to be designed to encourage enterprise and not stifle. In fact, the Inland Revenue claimed that without the changes IR35 would bring about, "it would be very difficult to target support at genuine entrepreneurial activity".

### Create a plan with some objectives, and stick to it

The original rules proposed by the Inland Revenue were clear, unambiguous and well reasoned. They postulated that a certification scheme might be the solution that removed the burden of compliance from clients and enabled legitimate contractors in business on their own account to self-certify, with understandably draconian sanctions for those caught lying or bending the truth.

But whatever the then Chancellor Gordon Brown's and the Treasury's original objectives, the IR35 legislation soon came to undermine genuine entrepreneurialism, not support it. The Inland Revenue, which became HM Revenue and Customs (HMRC) in 2004, appeared to implement the legislation without any clear strategy or objectives, lashing out at disparate contractor targets, seemingly at random.

<sup>1</sup> <http://www.hmrc.gov.uk/ir35/origsum.htm>

<sup>2</sup> <http://www.hmrc.gov.uk/ir35/ir35.htm>

<sup>3</sup> <http://www.hmrc.gov.uk/ir35/origsum.htm>

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Added to the confusion over exactly why IR35 was needed was the dreadful legislation that ultimately became law. But is ‘dreadful’ too strong a word? Well, tax, accountancy and employment law professionals, and a good few ex-tax inspectors themselves, have labelled IR35 variously as badly drafted, poorly thought through and lacking the key component of granting workers caught by the legislation with the employment rights it was originally intended to provide.

Anecdotal evidence to confirm these harsh criticisms abounds, much of it based on interviews, undertaken by ContractorCalculator journalists, with contracting sector experts operating during the time that IR35 has been in force. Other stark evidence came to light during the research conducted in October 2009 to create the ContractorCalculator IR35 Special: 10 years that shook and shaped the world of UK contractors. Taken together, the feedback suggests that the consultation process completed by HMRC was largely ignored by the Treasury, which proceeded to draft the legislation in the shape it thought best, rather than what was needed or recommended.

### IR35’s objectives – what’s the point of it?

Because of the wide range of consultants, contractors, interims and freelancers that have been targeted by HMRC, it is difficult now to determine what the true objective of the tax actually was. Examining both IR35’s original stated purpose and how it has since been applied, the objectives of IR35 appear to have been to:

- Tax disguised employees, like permtractors
- Prevent employees ‘doing the Monday-Friday thing’
- Tax high-earning contractors who pay themselves with a combination of low salaries and relatively high dividends
- Protect vulnerable lower-paid and low-skilled workers from exploitation (ie not the type of professional ‘contractor’ or ‘freelancer’ who reads ContractorCalculator and uses its calculators and information services)
- Place a tax premium on being a high-earning, flexible knowledge worker choosing a limited company, or partnership, as a trading model for their contracting.



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## The widest possible consultation should take place before any recommendations are put forward

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Whilst the first two objectives have the potential to protect tax revenues being lost through tax avoidance, clearly IR35 has become a victim of the 'law of unintended consequences'. A combination of poor objective setting, drafting and implementation has resulted in IR35's 'police force', HMRC, losing sight of what was originally intended. This has led to inconsistent implementation and the scatter-gun punishment of a broad stakeholder group of entrepreneurial small businesses.

### Lessons on setting objectives for IR35's successor

What can be learned from the history of IR35 that can assist the OTS in creating a set of recommendations for Treasury officials and ministers as part of its review of small business taxation in general, and IR35 in particular?

The first IR35 challenge for the OTS is likely to be to create a set of clear objectives that set out exactly what the new tax is supposed to achieve. Also needed is a forceful footnote in the recommendations suggesting that this time around considerably more care is spent ensuring the stated objectives are allowed for by law. In particular:

- The widest possible consultation should take place before any recommendations are put forward; fortunately, OTS appears to be very proactive in seeking out and inviting the involvement of numerous experts
- IR35's replacement should set out in clear and unambiguous terms exactly what type of avoidance it is targeting, who will be affected, why and how
- Any IR35 successor legislation should be thoroughly and carefully drafted, with its implementation tested on industry professionals as well as other stakeholders, and it must re-establish the certainty in the tax system for contractors which has been lost since the introduction of IR35
- A post-implementation evaluation and refinement process should be undertaken, to ensure that adjustments can be made for any unforeseen consequences of the legislation.

The final lesson of IR35 is that any successor to it must be unambiguous in purpose; it should be clear to everyone subject to, as well as to those enforcing it, exactly what the law is for and how it will be implemented. IR35 introduced an unacceptable level of uncertainty to the tax affairs of not only those clearly within its scope, but also a penumbra of workers and small businesses unintentionally caught, which has no place in its replacement.

# The evolving context of IR35

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The Labour government seemed neither to understand the mechanics and dynamics of the flexible knowledge-based workforce nor the benefits it could bring to UK plc

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Contracting in 2000, when IR35 was first introduced, was in many ways done in a very different industry and within a vastly different context. Yet, in other ways, contractors and contracting have not changed all that much.

Certainly the context in which the Office of Tax Simplification (OTS) is completing its current review of IR35 will have some marked differences from the 1998-2000 period when the Treasury and the then Inland Revenue was laying the foundations of what was to become the IR35 legislation that is still in force today.

But whether that context is more or less favourable as a base from which to create and launch new tax legislation to succeed IR35 has yet to be determined. Certainly, the change in government from Labour to a Conservative-Liberal coalition may result in a positive outcome for contractors, although that has been far from proved. What is certain, though, is that the economic, fiscal and market landscape is rather bleak.

## Changed political ideology

Although the coalition government has yet to prove its pro-small-business and pro-contracting credentials, it does not appear to view contractors with the same degree of suspicion as many industry commentators would argue the previous Labour administration did.

Where the Labour government seemed neither to understand the mechanics and dynamics of the flexible knowledge-based workforce nor the benefits it could bring to UK plc, the Coalition appears to have. Fair evidence of this can be seen in the creation of OTS and the review of small business taxation and IR35.

However, we are in the early days of a potentially five-year administration. So, whilst historically the Conservative majority of the 'ConLib' Coalition has a reputation for favouring business, the business it has favoured tends to be 'big' and, despite all the rhetoric we have so far heard, small to medium sized enterprises (SMEs) haven't yet seen any real action.

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## Looming legislation in the form of the Agency Workers Regulations coming into force in October 2011 could derail the efforts of a significant chunk of the flexible workforce

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### Contractors are good for the economy

According to its terms of reference, the key economic issue OTS must consider in its recommendations are that any changes to tax legislation should be 'revenue neutral', meaning no loss of tax yields to the Exchequer. Clearly a buoyant economy means greater tax yields, and a thriving and less regulated flexible workforce should be good for the economy both in itself and through greater tax receipts.

And, in theory at least, the flexible knowledge-based workforce is exactly what the economy needs to accelerate the economic recovery. PCG's 'Freeing Up Potential' theme for its 2010 National Freelancers Day is potentially what the coalition government could do simply by leaving contractors to get on, unfettered, with supporting UK enterprises.

But looming legislation in the form of the Agency Workers Regulations coming into force in October 2011 could derail the efforts of a significant chunk of the flexible workforce, umbrella company contractors and those on agency payrolls, by effectively increasing costs and reducing the very flexibility that makes contractors so attractive to end users.

### Evolving market dynamics

PCG research published in 2008 estimates that there are 1.4m flexible workers in the UK, comprised of contractors, freelancers, consultants, interims and other kinds of flexible workers, a figure that is said to have increased by 10% from 1998.

But indirect evidence suggests that, compared to ten years ago, contracting is in a relative slump. According to data from JobsAdsWatch.co.uk, there were 197,000 IT jobs being advertised in the first quarter of 2000 compared to 80,921 being advertised in the third quarter of 2010.

This does not confirm the absolute number of contractors, but does suggest there are fewer opportunities now in one of contracting's largest segments compared to when IR35 was being formulated. Will this possible reduction of potential have a bearing on OTS choices during its review? Would a more benign tax regime help reverse this decline?

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## Managed Services Companies Legislation: the rise and fall of the composite company

IR35 caused turmoil in the contracting sector, but it is debatable as to whether it had as big an impact as the Managed Services Companies (MSC) legislation introduced in 2007 that forced a significant number of contractors to drop the limited company model and fuel the growth in umbrella companies and offshore solutions such as employee benefit trusts (EBTs).

The movement of contractors into the EBTs, which HMRC has firmly in its sights for future legislation and anti-avoidance targeting, and the much greater migration, in volume terms, of contractors into umbrella companies as a result of the MSC legislation may have slashed the perceived avoidance problem IR35 was introduced to combat at a stroke.

EBTs, and other offshore solutions, contribute little to the Exchequer, but the number of contractors adopting these trading models is likely to be small, particularly as the recently enacted Disguised Remuneration legislation has effectively put an end to the benefits of joining EBTs. However, even only the top five umbrella companies employing an estimated 50,000 contractors are believed to collect over half a billion in income tax and National Insurance Contributions (NICs) each year.

Wholesale movement of contractors across different trading models highlights a knowledge gap that is certainly present now, and based on today's evidence was present in 1999. The scale of suspected avoidance through disguised employment has only ever been estimated, and arguably wildly estimated at that.

## Contracting is maturing as an industry sector

There is no doubt that, as an industry sector, contracting is maturing. It has a thriving service industry that has grown significantly in ten years. Witness, for example, the growth and decline in composite companies, and subsequent mushrooming of the umbrella company sector and the substantial tax revenues umbrella companies collect on behalf of HMRC.

IR35 has spawned an entire services industry that will no doubt morph into catering to contractors' needs to manage the implications of IR35's successor. There are membership organisations such as PCG for contractors and 'trade bodies' such as the Freelance and Contractor Services Association (FCSA) for service providers. In addition, contractor accountancy is informally recognised, and formally marketed, as an accounting sector specialism.

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## The context in which OTS is reviewing IR35 is very different and potentially more positive for contractors than that of a little over ten years ago

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Although the state of the contracting sector may well have no direct bearing on the choices made by OTS, contracting now has a much stronger, influential and probably more professional lobbying voice than a decade ago. And it is possible that the quality of information about the scale of any avoidance problem within the sector could be improved on that available in 1999.

The context in which OTS is reviewing IR35 is very different and potentially more positive for contractors than that of a little over ten years ago, when the Treasury was engaged in the task of creating IR35. Following the MSC legislation and the growth in compliant umbrella companies, the scale of the problem may be much less than in 1999.

At the very least, OTS appears to be much more receptive to the views of stakeholders than the Treasury was in 1999, which could bode well for contractors in the creation of what will hopefully be a less destructive replacement for IR35.

# Why IR35 and its current enforcement is not working

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That contractors should rush forward to voluntarily sacrifice up to 25% of their income in order to comply stretches credulity

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IR35 started life as an orphan and the legislation was doomed to fail as being unenforceable. From the outset, IR35 took the sort of employment law solution normally created by employment law experts and judges and applied it to a taxation problem to be solved by contractors and tax inspectors. The tests of employment are simply too complex to work when being applied to what is essentially an everyday taxation issue. The established tests of employment have also been shown to be unrealistic when applied to 21st century knowledge workers.

Then there is the major flaw that IR35 relies heavily for enforcement on self-certification by contractors. That contractors should rush forward to voluntarily sacrifice up to 25% of their income in order to comply stretches credulity, although many contractors initially did just that out of ignorance.

The final nail in the coffin of IR35 is the issue of enforcement and the low probability of contractors being found out and successfully tackled. HMRC certainly lacks the resources and expertise to effectively enforce the legislation now, and its enforcement earlier in the decade was highly variable, particularly when the scoreboard of successful prosecutions versus HMRC defeats is examined. Was IR35 doomed to failure from the outset?

## Can simple, objective tests determine if a worker is a 'disguised employee'?

HMRC and the courts always stress the need to focus on the reality of a relationship between worker and hirer when determining employment status. But when the reality of modern knowledge workers is examined in greater detail, it's obvious that employment law simply hasn't kept pace.

Contractors and freelancers frequently perform tasks that are also performed by employees. Employees complete projects also undertaken by contractors. Employees stay with an employer for a few months and move on. Contractors can be with a client for years. So what exactly is there to distinguish between the two?

And can a truly objective set of tests be created to distinguish between workers who exhibit exactly the same characteristics in reality, and only differ in their contractual relationships that convey rights and a job title on one worker and not on another.

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Laws don't work when people don't consent to be governed by them...historically, if a law is perceived to be grossly unfair, mass disobedience can result

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### The key tests as they are applied to knowledge workers: complex and not relevant

The tests of employment used under the IR35 legislation to determine whether a worker is a 'disguised employee' who should be taxed accordingly suffer both from their complexity and their irrelevance. They are based on years of case law that, when applied in their true context at a tribunal or in a court, are interpreted by legal experts, who seldom even agree themselves on what the case law means.

So how can mere contractors and tax inspectors, who are already highly skilled in their own right in their own areas of specialisation, be expected to become employment law experts as well?

And do control and substitution, currently considered by experts to be 'killer factors' when determining employment status, really apply to knowledge workers? An expert is usually hired because they are just that – an expert. Of course the client won't want a substitute sent in the expert's place.

Can a knowledge worker – such as an IT software developer, engineer, accountant or other highly skilled individual – be told exactly how in detail to perform their role, such as what specific line of computer program code to write or how to perform a calculation? Clearly not, otherwise they would not be highly skilled knowledge workers.

### HMRC relies on fear and contractors have called its bluff

Like any law in a democracy, tax legislation largely works because most of the population consent to abide by it. Most people understand that taxation is necessary and largely abide by the rules. The 'carrot' for doing so is that taxation buys the public sector services we all require. HMRC also wields a 'stick' in the form of penalties and interest charges when taxpayers are caught not abiding by the rules.

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## What gives HMRC any moral authority to determine whether a worker is employed against their will, take their money and give no rights in return?

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But laws don't work when people don't consent to be governed by them. And historically, if a law is perceived to be grossly unfair, mass disobedience can result. Fortunately, the law-making process in the UK has become pretty effective over the centuries, but it does still throw out the occasional anachronism, like IR35. What gives HMRC any moral authority to determine whether a worker is employed against their will, take their money and give no rights in return?

IR35 is a law that, experts agree, was poorly drafted and with no notice taken of the consultation process. It takes a huge chunk of the affected taxpayer's income and gives nothing in return, is hugely complex, is based on irrelevant rules and has been implemented on an almost random basis. Occasionally, it has even destroyed the lives of completely innocent small business owners.

Is it any wonder, especially when you consider HMRC lacks the resource to enforce the tax code, that many contractors choose to take a risk, call HMRC's bluff and ignore IR35?

Fortunately, the current legislative landscape is another planet compared to that of 1999. Both the government and the OTS appear to be receptive to input from experts and affected parties. But the flaws that have rendered IR35 impotent await as potential traps for those deliberating its replacement.



# Why IR35 or any changes will never work

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Further barriers in the form of new and potentially costly legislation could fundamentally damage the UK's competitiveness

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Below we present a range of possible replacements for and successors to IR35 that may be considered by the Office of Tax Simplification (OTS) as it undertakes its review of IR35. But it also becomes apparent, when each alternative is subjected to scrutiny, that it is as likely to be unworkable as the legislation it might replace.

In chapter 4, we established that IR35 in its current form is clearly not working – its original objective, to identify workers who are really ‘disguised employees’ and tax them accordingly, have simply not been met.

But is this a problem that can actually be solved? Is there even such a creature as a ‘disguised employee’, or are there just workers who perform tasks and get paid? And aren't flexible, highly skilled knowledge workers exactly what UK PLC needs to consolidate the recovery and compete on a global stage?

Further barriers in the form of new and potentially costly legislation could fundamentally damage the UK's competitiveness. Other countries with knowledge economies and a flexible workforce with similar characteristics to the UK's have tried to address the issue of disguised employment. Their experiences provide important lessons for the UK policymakers currently considering options to replace or update IR35.

## OTS has three basic options

There appear to be three basic options available to the OTS as it considers what alternatives to provide to the Treasury on IR35's replacement or ‘simplification’:

- Do nothing – maintain the status quo and keep IR35
- Repeal IR35 and do not replace it
- Amend IR35 or replace it with something completely new.

The effectiveness of the option of keeping IR35 as it is very much depends on HMRC and its motivation to target contractors. That will in part be politically driven, but also based on the likely return on effort and investment. The little evidence available to chart the effectiveness of HMRC in generating IR35-related tax yield suggests that targeting contractors gives poor return on investment.

Option two, to repeal IR35 and not replace it, would be a victory of sorts for contractors and lead to certainty in contractor's tax affairs. And with the Managed Services Companies legislation in force and apparently working well, it is unlikely that there would be wholesale migration away from umbrella companies into contractor limited companies, as the reasons contractors choose umbrellas no longer hinge solely on IR35. But would this second option be politically acceptable?

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There are tasks that can be performed equally well by employees and contractors where the only difference between the two situations is the existence of an employment contract and job title

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### Change or replace IR35 with a successor – the options

So, what of the third option? To create a successor to IR35 in the form of amended legislation or an outright replacement presents a huge challenge. As we demonstrated in chapter 4, the current tests of employment cannot be applied to 21st century flexible knowledge workers.

So, what could form the basis of a new set of tests or alternative solutions? Here are some options:

- Pre-assessment of assignments or a certification scheme for contractors
- Empirical tests: eg More than 80% income from one client in one year or assignments lasting more than two years would be seen as disguised employment (similar to Australia)
- Shift the burden of proof onto clients and agencies (similar to the USA)
- A contractor can only work on projects, with ongoing work viewed as disguised employment
- Workers leaving employment on a Friday and returning to essentially the same job on a Monday as self-employed are automatically classed as employees and are taxed accordingly
- Provide employment rights to contractors passing 'tests of employment'
- Introduce surcharges on dividends from 'close' companies
- Create a definition of a personal service company (PSC) and tax all remuneration as employment income
- Inclusion or absence of contractual restrictions, such as exclusivity, could indicate whether or not a worker is employed.

If new tests are introduced to determine whether a worker is a 'disguised employee' for tax purposes, and which differ from the current tests of employment to determine whether a worker is an employee and qualifies for employment rights, what implications would these tests have on employment status?

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**In attempting to tackle the issue of tax avoidance as a result of disguised employment, no other country has yet arrived at a workable solution**

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Can employment law and tax laws be separated in this way, or will these tests also be brought into employment tribunals as further evidence by specialist employment lawyers?

And the fact remains that, as highlighted in chapter 4, there are tasks that can be performed equally well by employees and contractors where the only difference between the two situations is the existence of an employment contract and job title.

### **Lessons learnt outside the UK**

Several other nations with flexible labour markets and free-market based economies similar to the UK have identified 'disguised employment' as a tax-avoidance issue and created their own legislation.

To the external observer, the 'IR35' equivalents in the United States, Canada and Australia have left contractors trading in those nations in similar legislative limbo to their UK counterparts (eg Canada), treated poorly (eg the USA) or battered with draconian legal sledgehammers (eg Australia).

In attempting to tackle the issue of tax avoidance as a result of disguised employment, no other country has yet arrived at a workable solution.

This suggests two things: either the UK will be the first to do so, or – which is much more likely – there really is no solution because there is no such thing as a 'disguised employee'; there are just workers who get paid.

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## Why IR35 solutions, successors and replacements won't work

Complex tests, such as those currently applied to determine worker status, have been shown to be far too complex and ambiguous to provide the certainty that contractors require in their tax affairs and HMRC needs to generate tax revenues. And such tests simply can't be applied to 21st century's highly skilled knowledge workers for whom the concepts of 'control' and 'substitution' are an irrelevance.

On the other hand, simple tests are too transparent and likely to suffer from the 'law of unintended consequences', as has been the case in Australia , or will be quickly and easily worked around. Tests using company structures and law run the risk of catching huge numbers of innocent small businesses.

Making agencies and end-user clients responsible for the policing process, as is effectively the case in the USA , results in a poor deal for contractors. If applied to the UK, they might also lead to the very real risk of driving clients to find offshore service providers.

The OTS has been tasked with making recommendations about the wider issues of small business taxation, and it could be in that wider arena that there will be a solution to ensuring all workers pay their fair share of tax, irrespective of how they trade.

# an interim, post-IR35 contractor tax landscape

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**Further ‘sticking-plasters’ in the form of amendments and adjustments to IR35 specifically, and tax legislation generally, will not provide contractors and other taxpayers with the fairness and certainty they require**

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In this final chapter analysing IR35 and possible routes forward for the Office of Tax Simplification (OTS) as it reviews UK taxation with a view to simplifying it, we draw conclusions about IR35’s future and the limited options that could actually work in practice.

What has become clear is that further ‘sticking-plasters’ in the form of amendments and adjustments to IR35 specifically, and tax legislation generally, will not provide contractors and other taxpayers with the fairness and certainty they require. Nor will they provide the government and citizens with the tax revenues they should rightly expect.

That UK taxation requires simplification is not disputed by taxation experts; indeed it is the OTS’s reason for existing. And such simplification could lead to a fairer taxation system that is likely to make contractors’ “employment status” and, by default, IR35 irrelevant. But this won’t happen quickly and IR35 is likely to be with contractors for at least the medium term, while the bigger problems are addressed.

So, when predicting the post-IR35 landscape, an interim stage should be considered in which IR35 will still be in force, but perhaps implemented differently and more effectively. In the longer term, fundamental changes to taxation should follow that will address root causes of tax avoidance, by changing how income is classified and taxed for all workers, regardless of their employment status or trading vehicle.

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## IR35: summary and current status

In the ten years since IR35 was first implemented, much has changed, and in chapters 2 to 5 we summarised IR35's objectives, changing context, reasons for failure and potential solutions:

- In chapter 2, it was established that IR35's objectives from the outset were clear – to target disguised employees and tax them accordingly – but in the process of drafting the legislation, consultation and implementation, the Treasury and HMRC lost their way, and contractors bore the brunt of this, with many being unfairly targeted
- Chapter 3 examined the evolving context of IR35 ten years on, with a new government and a bleak economic landscape in which increased tax revenues are imperative, but contractors could provide UK PLC with the highly skilled knowledge-based flexible workforce it needs to remain competitive and drive economic growth
- According to chapter 4, IR35's enforcement was doomed to fail, given that the legislation applied incompatible employment law solutions to a taxation problem and failed to recognise the irrelevance of traditional employment tests to modern work patterns; a requirement for self-certification by those affected and lack of resources for HMRC has resulted in IR35 being widely ignored
- Chapter 5 highlights the three options open to the OTS: firstly, to do nothing; secondly, to repeal IR35 and not replace it; or thirdly, to amend IR35 or replace it with something new. Options 1 and 2 are probably politically and fiscally unacceptable, but the range of solutions to option 3 could be unpalatable to contractors, clients and government, leaving no-one satisfied.

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## IR35's undeniable truths

This analysis and all the evidence from the contracting sector leads to the inescapable conclusions that:

- IR35 in its current form is not working
- IR35 in amended form or by a replacement will never work
- The underlying issue is the UK system of taxation and enforcement, which must be fixed by taxing people the same, regardless of how they earn an income
- The UK tax system won't be fixed quickly, so any IR35 solutions must be in two stages; making the best of what's in place in the medium term, and then addressing the underlying issues in the longer term.

## The medium-term 'sticking plaster' for IR35

Complexity, failure to self-certify and poor enforcement through lack of targeting and resources were identified in chapter 4 as the root causes of IR35's lack of effectiveness so medium-term solutions could include:

- Identifying the scale of the problem and the amount of tax actually being avoided from the outset, by gathering more information, possibly via existing channels such as tax returns and P35s
- Having established the scale of the problem and likely return on investment, to properly resource enforcement and develop specialists at HMRC, using data gained from tax returns and P35s for focused targeting of 'perm-tractors' (long term contract workers indistinguishable from employees in every way except by virtue of not having an employment contract)
- Place a time deadline on IR35 investigations, so contractors are not left with up to five years backdated taxes, interest and penalties; this alleviates much uncertainty and could also result in increased self-certification, rather than an 'I might as well be hung for a sheep as for a lamb' mentality of avoidance
- Extend self-certification and the use of IR35 experts, in parallel with what happens in accountancy and with the concept of auditing. Use preparation of company accounts and tax returns by accountants as an opportunity to confirm IR35 status.

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In reality the boundaries between the employee and self-employed are often as basic as a job title or as absurd as whether or not the worker has access to the canteen

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## 20th Century taxation can no longer meet 21st Century needs

Flexible workers, such as contractors, have always formed part of the UK's workforce and contributed to the strength of UK Plc. Research by organisations such as the Confederation of British Industry<sup>10</sup> and PCG<sup>11</sup> suggests that the UK's highly skilled and flexible knowledge workforce has never been greater. And labour market statistics<sup>12</sup> by the Office of National Statistics demonstrate that self-employment is at an all time high.

However, tax legislation has not kept pace with evolving workforce trends and, as highlighted in Part 4, the traditional tests of employment are simply not relevant to modern flexible knowledge workers. Nor is the concept of a 'disguised employee' valid in the 21st century workplace, where in reality the boundaries between the employee and self-employed are often as basic as a job title or as absurd as whether or not the worker has access to the canteen.

As the OTS and other tax reform organisations work towards overhauling the UK's complex and inefficient tax system, creating an environment in which everyone is taxed on their income regardless of how it is earned, IR35 will no longer be needed.

But for the next few years at least, IR35 is here to stay and likely to remain either in its current form, or potentially changed into something even more draconian with greater levels of enforcement. Genuine contractors in business on their own account and adopting IR35-status management best practice should have nothing to fear, and can look forward to a time when UK taxation encourages the flexible workforce to prosper.

<sup>10</sup> CBI/Harvey Nash Employment Trends Survey 2009

<sup>11</sup> Defining and Estimating the Size of the UK Freelance Workforce (Kingston University) 2008

<sup>12</sup> <http://www.statistics.gov.uk/pdfr/lmsuk1210.pdf>



# Dave Chaplin of ContractorCalculator

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ContractorCalculator is the UK's leading website for contractors and freelancers.

It has been online and independent since 1999, when it launched [ir35calc.co.uk](http://ir35calc.co.uk) to help contractors count the cost of the then newly released IR35 legislation.

Still owned by founder and former IT contractor Dave Chaplin, the site has grown dramatically since then to become the expert guide to contracting. Dave is still actively involved in its management, supported by a dedicated team of contractors and freelancers.

ContractorCalculator's ABCe-audited monthly audience of over 100,000 regular readers is made up of contractors, freelancers, interims and consultants from the IT, telecoms, engineering, oil, gas and energy, business, marketing and medical sectors. They keep coming back as the site offers:

- A comprehensive range of essential online financial, salary and tax calculators
- A high quality daily news service from a professional editorial team
- Expert commentary and analysis from industry and sector leaders
- More than 1,000 online articles and guides suitable for beginners and veterans
- Access to leading contractor services.

As a result of this fantastic resource for those new to contracting and experienced old-hands, ContractorCalculator has been dubbed 'The Expert Guide to Contracting'. It is also the publisher of the definitive guide to UK contracting – **The Contractors' Handbook: the expert guide for UK contractors and freelancers**

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## Dave Chaplin

When IR35 was first announced in 1999, contractors and freelancers had no idea about the massive impact it was to have on their livelihoods. Until, that is, ContractorCalculator founder and CEO Dave Chaplin – who is also a mathematician and at that time was a leading IT contractor – wrote and published online the first ever interactive IR35 calculator.

As a result of Dave's pioneering work, when the shocking truth emerged about the financial impact of IR35 on legitimate contractors' earnings, the contracting and freelancing sector was never to be the same again.

And while still working as an IT contractor for blue chip clients in London's financial district, Dave built the first contractors' and freelancers' portal, including high quality news and in-depth guides, around a range of online financial calculators that became ContractorCalculator.

Dave's passion for ensuring that today's contractors and freelancers are equipped to flourish prompted him to write the contracting sector's definitive guide – **The Contractors' Handbook: the expert guide for UK contractors and freelancers.**

By 2004 Dave was working full time on the website and has since created a team comprising business and financial journalists, marketers and web designers, all experienced and highly qualified contractors and freelancers. These ongoing developments mean the site is produced by contractors and for contractors, with Dave as its CEO and Editor in Chief.

# Contact us

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