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HMRC Intermediaries Legislation (IR35): discussion document

Response from the Employment Lawyers Association

30 September 2015

Employment Lawyers Association Response

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Introduction

The Employment Lawyers Association (“ELA”) is a non-political group of specialists in the field of employment law and includes those who represent Claimants and Respondents/Defendants in the Courts and Employment Tribunals. It is therefore not ELA’s role to comment on the political merits or otherwise of proposed legislation, rather to make observations from a legal standpoint. The ELA’s Legislative and Policy Committee is made up of both Barristers and Solicitors who meet regularly for a number of purposes, including to consider and respond to proposed new legislation.

A sub-committee, chaired by Stephen Ratcliffe (Baker & McKenzie LLP), was set up by the Legislative and Policy Committee of ELA to consider and comment on the HMRC consultation. Its report is set out below. Members of the sub-committee are listed at the end of this paper.

1. Any evidence on the use of other types of intermediaries, aside from PSCs, to which IR35 may apply.

In light of the expansive scope of the agency workers legislation and managed service company legislation in chapters 7 and 9 of Part 2 of the Income Tax (Earnings and Pensions) Act 2003, and the fact that those provisions supersede Chapter 8, it seems unlikely that IR35 would apply to intermediary situations other than those involving personal service companies.

2. Any evidence on how PSCs currently operate IR35 and the issues that rules create for individuals and businesses across the market.

In our members' experience the use of personal service companies is widespread, particularly in the following sectors:

- IT, where it is common for business models to be based on the use of personal service company contractors who will be engaged on a project-by-project basis. This is common both in start-up businesses, creative digital businesses, and the wider IT sector;
- entertainment, particularly in contracts for on-screen "talent" and for production services;
- construction;
- transport, in particular road haulage, courier, and private hire businesses, as well as wider rail and aviation interests;
- security, in particular contracted-out venue security;
- the oil and gas sector; and
- the public sector.

Our members report that the use of personal service companies is seen as bringing significant benefits in terms of flexibility and minimising the exposure to the perceived burden and legal risk entailed in employing individuals. In many cases, the underlying business model of the client is seen to be predicated on the use of personal service company contractors.

On the part of the individual contracting as a personal service company, benefits include a limitation of potential legal liability (for example for negligence) by the use of limited company status. This option is also widely used for senior non-executive board members who have a well established portfolio career. Though in such cases the client may often prefer to engage the individual directly, the use of a personal service company for the provision of such services appears consistent with the wider portfolio nature of such individuals' careers. We note, however, that the new s.156A of the Companies Act 2006 inserted by s.87 of the Small Business, Enterprise and Employment Act 2015 will, once enacted, prohibit the engagement of personal service companies as non-executive directors.

Our members report two key issues with regard to the operation of IR35 at present, which are:

- (1) The calculation of applicable deductions under the IR35 rules is an extremely complex process. Absent professional accountancy support, it is unlikely that an individual engaging in a traditional personal service company relationship to which IR35 applies will be capable of undertaking such a complex calculation accurately. The calculation itself therefore constitutes a significant disincentive to the application of IR35 by the personal service company in question.
- (2) The application of IR35 requires a determination of whether, if the services were provided under a contract directly between the client and the worker, the worker would be regarded for income tax purposes as an employee of the client (or the holder of an office under the client). The second element of that test, relating to office-holding, is reasonably straightforward. However, the first requires an understanding of a significant body of case law setting out factors to be taken into account in determining whether an individual is an employee or self-employed for tax purposes. Furthermore, the existing test entails a degree of uncertainty, reliant as it is on weighing various different factors (control, integration, financial risk etc.) to determine, on balance, whether the individual is more likely to be considered an employee or genuinely self-employed. Again, at present it is difficult for an individual to determine whether that employment status test is satisfied absent professional advice.

In this regard, we would note that the Office of Tax Simplification's timetable for determining the new test of employment or self-employment is shortly awaited. It seems surprising, in that light, to suggest an alternative test may be applied in the IR35 context. It would seem more appropriate to apply the test which HMRC finally determines should be applied in the wider employment/self-employment context.

Notwithstanding that point, this working group would respectfully suggest that any test used to determine whether an individual is employed or self-employed will necessarily entail a degree of subjective interpretation and, with it, a degree of uncertainty. That is necessarily the result of applying one test to a great many different worker/client relationships. Should the existing legal test be replaced by another, that is likely simply to have the result of substituting one uncertain test for another. The test of "supervision, direction and control" referred to on page 8 of the discussion paper is arguably even more uncertain than the present test, since there has been little judicial consideration of its meaning. On a simple view, any worker is, at some level, under the supervision, direction and control of his client. The alternative of simply applying IR35 to all personal service companies after an arbitrary length of engagement would appear to result in personal service companies being taxed on a basis which may well not be the appropriate one and therefore inherently unfair.

If any test (other than an arbitrary duration-based test) for determining employment status will necessarily involve some degree of interpretation, that necessarily means

that there is a danger that a personal service company or client (whether professionally advised or not) will come to a different determination than HMRC on the same facts. That risks the personal service company (on the present law) or the client (if the suggestions made in the discussion paper are adopted) being penalised for what may be a legitimate difference of opinion. It therefore appears that the solution to that issue lies not in the application of an alternative legal test, but in resolving the risk that HMRC will take a different view from the taxpayer.

In the past, that risk has been minimised by the availability of an online questionnaire on the HMRC website, which enables the taxpayer to determine whether IR35 is likely to apply. If such a questionnaire were to be reintroduced, and taxpayers were notified that, if completed accurately, they were entitled to rely on it in the event of an enquiry from HMRC, that would appear to provide a considerably greater degree of certainty for all parties than is currently the case. Appropriate measures would of course have to be put in place to ensure that taxpayers who completed the questionnaire incorrectly could be appropriately penalised, and to encourage taxpayers to complete regular questionnaires to deal with changes to their position. However, in principle, none of those issues presents as great a challenge as the creation of an alternative one size fits all test for determining whether IR35 applies.

3. Any proposals for how to improve the effectiveness of IR35 that meet the objectives outlined in this document

As noted above, it is the opinion of those participating in this response that the continued application of the existing employment test would avoid introducing a new and invariably uncertain test which requires further clarification via (potentially) years of litigation. The uncertainty created by the existing test arises from the risk that the HMRC will take a different view of the status of the individual than the individual and/or the client themselves take. That uncertainty could be avoided by the application of the online questionnaire referred to above.

A further alternative would be for any HMRC investigation of non-compliance with IR35 rules to be by reference to the practices of the client (as is suggested in the discussion document), but for back-payments of tax to be recoverable from the personal service company in question. This would achieve HMRC's objective of being able to investigate the practices of large users of personal service company contractors rather than a great many individual personal service companies, while at the same time avoiding the risk of having to recover unpaid tax from the client when that tax has effectively been paid to the contractor. As noted below, should the proposed approach set out in the discussion document be adopted, it is likely to be a significant disincentive to the use of personal service companies.

4. Any views on the potential option outlined in this document which would result in the engager taking on a greater role in being responsible for operating IR35 including:

(a) Whether such an approach would be effective in achieving the objectives outlined in this document.

The proposal to place responsibility for compliance with IR35 on the client rather than the personal service company would not appear to achieve the objectives of protecting the Exchequer, levelling the playing field between employees and those who are self-employed or making the legislation as straight forward to comply with as possible. The likely result of such an amendment, absent a significant clarification of the circumstances in which IR35 is to apply (which, as noted above, will be very difficult to achieve in practice) is that clients may be unwilling to take the significant risk of an adverse HMRC determination. It is more likely that users of significant

numbers of personal service company contractors will simply cease to engage such contractors and will either:

- (i) employ those individuals directly (thereby leading to increased costs of compliance with employment obligations, and reducing flexibility); or
- (ii) engage individuals via temp agencies (also thereby increasing the underlying costs to business).

Where, as our members have reported is sometimes the case, the business model of the client is reliant on the use of personal service companies, the client will face the difficult decision of taking the risk of an adverse HMRC decision (which, as noted above, may arise from what is little more than a simple difference of opinion), or simply ceasing to trade. Such a commercial risk may be particularly unpalatable for the start-up and digital media communities, where flexibility and reduced cost is imperative.

With regard to the option of applying an arbitrary date after which the IR35 rules will be deemed to apply, this would provide certainty and ease of application in practice. It would of course require appropriate anti-avoidance drafting. Equivalent drafting has been provided in the Agency Workers Regulations 2010, so this would appear not to present a significant hurdle. However, it would appear to result in the application of (the equivalent of) employment tax obligations to personal service companies which, in many cases, will not be in a genuine self-employment relationship. It is unclear why, as a matter of principle, a personal service company which is in a genuine self-employment situation should fall with the ambit of IR35 simply by virtue of the effluxion of time if that underlying relationship remains one of self-employment not one of employment. The application of such a test would appear to have the unintended consequence that personal service company contractors will instead opt for personal self-employment (as opposed to being engaged through a service company) so as to avoid the application of IR35. That would not appear to achieve the objective of protecting the Exchequer; rather, it would simply transfer the issue of tax avoidance to a different provision of the legislation.

It seems more likely that the objectives set out in the consultation document would be achieved by simplification of the IR35 calculations combined with a reliable online questionnaire to determine (in a binding sense) whether the individual personal service company falls within the IR35 rules. Arguably, the objective of protecting the exchequer would be served thereby whether or not the penalty was imposed on the client or the personal service company itself, though it is acknowledged that enforcement action against larger entities in respect of a multitude of personal service companies may be a more cost effective option for HMRC.

- (b) Whether such an approach would be effective in achieving the objectives outlined in this document. How can it be made as straightforward as possible for engagers to determine whether IR35 should apply as part of their routine hiring conversations.**

See above.

- (c) Whether there are particular sectors or types of engagers which would face particular challenges.**

The particular challenge that would be faced, namely the significant disincentive on the use of personal service companies would likely be equally felt across all sectors in which personal service companies are particularly widely used. As noted above, the

risk of an adverse HMRC ruling would perhaps be particularly keenly-felt in the start-up and digital media industries, though the same would be true of any industry whose business model is dependent on the use of personal service company contractors or which is otherwise operating on small margins.

- (d) **How such an approach should work where a PSC is engaged by an individual rather than another business, and if there should be different rules which apply in these circumstances.**

It is unclear why, in principle, the application of the IR35 rules should be disapplied or applied in a different manner to circumstances where the end-user is an individual. However, the apparent problem which we presume underpins this question demonstrates the considerable uncertainty to which the test of "supervision, direction and control" may give rise in the event that it is used in replacement for the existing IR35 test. As noted above, in any circumstance where one individual is engaged to work for another, that first individual is arguably under the supervision, direction and control of the other to some degree. When a householder hires a tradesman, for example, that tradesman is under the direction and control of the householder, in terms of the work to be done, the standard to which it is to be done and the timescale to which it is to be delivered. That the individual tradesman applies his skill or experience in completing that job does not mean that he is not under the supervision, direction and control of the hirer. If it is the Government's position that the IR35 rules should not apply to this situation (hence this question), that tends to suggest that the underlying proposal itself is unsound, rather than that individuals should be arbitrarily excluded from the application of IR35 simply by virtue that the hirer is an individual.

- (e) **Any other views on the impacts of such a change and how they might be addressed to minimise any additional burden on engagers.**

See above.

- (f) **Any views on the implications of a change in the test which determines whether IR35 applies, both positive and negative, and what stakeholders' preferred approach would be.**

As noted above, other than an arbitrary duration-based test, it is unclear precisely what test could be implemented which would avoid the subjectivity inherent in determining whether a given situation is more akin to employment or self-employment. Simplification is naturally to be welcomed, but it appears that the present issue is uncertainty in how that test may be applied by HMRC, as opposed to uncertainty inherent in the test itself.

It seems unlikely that the adoption of the "supervision, direction and control" test will simplify matters to any material degree, since the precise meaning of that term is extremely unclear. It seems likely that, were such a test to be adopted, the existing somewhat complex case law would be replaced with new and equally complex case law to be developed over a number of years. In the interim, Personal service companies and their clients will continue to require expert advice as to whether IR35 applies, which advice would be considerably more uncertain than at present, since the precise meaning of the test will remain unclear for years to come. It is for this reason that we would respectfully suggest that the adoption of a statutory questionnaire or other HMRC-backed simplified determination together with simplification of the IR35 calculations would be welcomed.

30 September 2015

Members of ELA Sub-committee

Chair: Stephen Ratcliffe, Baker & McKenzie LLP

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