



The voice of freelancing

PCG Policy Briefing: IR35

PCG position: the case for reform is clear and urgent

Since it came into force in 2000, the intermediaries legislation, or “IR35”, has proved to be a failure by every conceivable measure.

- IR35 has placed a new cost burden on small businesses
- IR35 has perpetuated the abuse it was designed to stamp out
- There is no evidence that IR35 has generated increased revenue for the Treasury
- The Government has acknowledged that it is unable to implement IR35 fully
- IR35 has caused businesses to pay tax when they do not owe it.

IR35 should be repealed and a new measure introduced to address the real problem.

- PCG calls for a thorough review of employment and tax status in full consultation with the freelance community
- PCG’s preferred option is for the defects in employment status law to be remedied to prevent disguised employment relationships being possible in the first place; IR35 will then be redundant and can be repealed.

IR35: a bad diagnosis and a bad remedy for a genuine problem

- Disguised employment, which IR35 was intended to address, is a genuine problem
 - It occurs when a worker is engaged to work effectively as an employee, but on a commercial contract, thus not having any employment rights
 - Genuine freelancers do not wish to provide their services in this way and are often inconvenienced by restrictive employee-like conditions in their contracts, which can also confuse their employment and tax status
 - Other workers would rather have the protection of employment rights; for them, such a relationship is an abuse
- IR35 is based on an assumption that disguised employment is instigated by the worker in an effort to avoid tax, for instance in the “Friday to Monday” scenario of leaving a job only to return as a contractor doing exactly the same work in exactly the same way
 - In fact, disguised employment works primarily to the advantage of employers, who use it to engage workers whom they can direct like employees but without having to give them employment rights
 - Any measure aimed at tackling disguised employment must therefore seek to influence the employer, not just the worker
- IR35 seemed to arise from a fundamental misunderstanding of freelance working, and from an outdated mode of thinking which seems to regard any working relationship other than that of employer and employee to be some kind of abuse.

IR35: How it works

- IR35 applies when a worker supplies their services through a limited company or other corporate structure, plus an agency in many cases, to an end-client
- It allows HMRC to “look through” the company and assess whether the underlying relationship between the worker and the end-client is one of employment
- If the worker is found to be a “disguised employee” the fee paid by the end-client to the contractor’s company is taxed as if it were a salary, with full PAYE income tax and employees’ NICs, plus employers’ NICs as well
- Answering the counter-factual question (“if there were no company in the way, would this be an employment relationship?”) is a complex and difficult exercise in law
- IR35 does NOT create an employment relationship: the worker is taxed as an employee but is not entitled to any of the rights usually associated with employment.



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IR35 has perpetuated the abuse it was designed to stamp out

- It has become common for companies to take a conscious decision to hire workers using contracts caught by IR35
- This is cheaper and more convenient for the company, which is absolved from paying NICs or providing employment rights
- The workers, meanwhile, are left with a higher tax bill and no rights at all
- This kind of exploitation was the chief justification for introducing IR35 in the first place: rather than putting a stop to it, IR35 has formalised it.

IR35 has damaged small businesses and the economy as a whole

- PCG estimates the value of freelancing to the UK's economy is approximately £100 billion per annum
- As the most sophisticated and developed example in the world, the UK's freelancing model offers a genuine competitive advantage
- IR35 creates costs for businesses:
 - Most freelance businesses feel it is necessary to take out insurance against investigation for IR35: HMRC routinely investigates genuine businesses on suspicion of being disguised employees under IR35, thus obliging them to insure against the possibility
 - As an extra precaution, many contractors will pay to have any new contract professionally reviewed to ensure it is not IR35-caught; even when they don't, they are obliged to waste a lot of time looking at their contracts for IR35 purposes
 - Businesses who are investigated may be obliged to spend many years and hundreds, or even thousands, of pounds fighting off investigations if they are not insured
 - Even though freelance businesses will usually be found not to owe any money, resisting an aggressive HMRC investigation is expensive, time-consuming and distressing
 - The money and effort involved would be more effectively deployed in creating wealth.
- The Government has not monitored the impact of IR35: anecdotal evidence abounds, however, of contractors closing their businesses because it makes them unviable, or even because IR35 investigations have put them out of business directly.

IR35 may actually have cost the government money

- PCG's approved suppliers have handled 1,411 IR35 investigations as of April 2007, which typically last over two years but have been known to last up to twice as long
- Only three of these have resulted in the contractor being found to be within IR35
- The Government keeps no records of how much these fruitless investigations are costing the taxpayer, or of how many IR35 investigations are undertaken, successfully or otherwise
- The Government's RIA of 1999 estimated that IR35 would generate an extra £220 million each year in NICs: yet Treasury ministers have confirmed to the House of Commons that they are unable to identify how much revenue is raised by IR35.

The Government has recognised the failure of IR35

- Reports began to circulate in August 2006 that HMRC is reducing drastically the number of inspectors working on IR35 such that in most cases it will no longer be enforced: this seems to confirm that it has failed, and cannot be effectively implemented in practice
- In his 2007 Budget, the Chancellor removed a whole category of company structure ("Managed Service Companies", or MSCs) from the scope of IR35 and applied a new tax treatment to them because IR35 could not be enforced



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- The measures proposed for MSCs take the sensible approach of setting out a range of defined criteria against which companies can be assessed: this suggests the Government has recognised that asking a highly complex counter-factual question, as IR35 does, is unworkable.

IR35 is inappropriate for a self-assessment system

- The success of PCG members in demonstrating that they are not caught by IR35 suggests that when a contractor stands their ground, they will usually show that HMRC does not have a case against them
- These figures do not, of course, include businesses who have simply paid up due to wrongly believing themselves caught or simply to avoid a lengthy exchange with HMRC
- It is clearly unacceptable for taxpayers to be paying tax simply because the system is too complicated for them to be able to tell that they do not owe it, or because they do not want to deal with a lengthy and stressful investigation
- The figures quoted above showing HMRC's enormous difficulty in implementing IR35 are far too clear-cut to represent a coincidence or statistical fluke: HMRC is clearly trying to pin IR35 on contractors who are not caught, either through ineptitude or a cynical attempt to extract tax that is not lawfully owed - neither of which should be tolerated from the UK's tax authority
- HMRC's near-100% failure rate in investigations known to PCG clearly shows that IR35 is hopelessly complicated and that even the Revenue does not understand how to apply it
- Under IR35, a contractor's tax bill can be determined by a contract they have never seen and to which they were not a party - the "upper contract" between their client and the agency. In a self-assessment system, this is plainly unacceptable.

There are many potential and better methods for solving the problems addressed by IR35

- PCG's preferred solution would be for employment status to be clarified so that it is not possible to establish "disguised employment" relationships at all
 - One way of achieving this would be to define an employment relationship in statute by enacting the main current common law tests
 - It would also be necessary to stipulate that tribunals and courts may infer an implied contract of employment with reference to these tests, such that in any "disguised employment" relationship, employment rights rest with the end-user
 - This would enact the current common law situation as PCG currently understands it, following the judgment in *Cable and Wireless v Muscat* (2006)
 - With "disguised employment" a legal impossibility, IR35 can be repealed
- Alternative options exist that are also worthy of investigation
 - IR35 status could be defined by the same criteria as used for other measures such as TUPE: IR35 status tests would therefore be replaced by a single question to end-users: "In the event that your company was to outsource the organisational area in which the contractor worked, would you accept that your arrangement with the contractor is bound by TUPE terms?"
 - This would have the advantage of using a well-understood existing set of rules, but the disadvantage of retaining IR35's complex "counter-factual question" approach
 - There are no doubt other potential approaches that merit consideration.

By any sensible measure, IR35 has failed: there can be no justification for retaining it. PCG looks forward to working with HM Treasury to develop and introduce the necessary reform.