Submission by the Professional Contractors Group to the Liberal Democrat Tax Commission

Introduction

The Professional Contractors Group is the trade association for the UK's freelance consultants and contractors. Our members work in a wide variety of sectors including IT, project management, engineering and oil and gas extraction. PCG has long called for consistency, clarity and common sense in the tax system: the organisation developed from an IR35 protest group and retains a strong interest in tax issues. PCG has lobbied the government extensively and also sought clarity on various points of tax law by supporting numerous significant test cases in the courts.

PCG is primarily concerned with business taxation. It is the case, however, that very often the business revenues of our members relate very closely and very directly to their personal income; the following response will therefore consider personal taxation to a limited extent. The response will not consider levels of taxation at any great length: PCG is far more concerned with what is taxed and how it is taxed than with how much tax is levied on it, which remains essentially a political consideration. It will first be necessary to set out the context in which PCG has come to consider these issues.

Tax and employment status in historical context

Although business taxation is the main issue under consideration here, it cannot be entirely separated from issues of employment status, for reasons that will be set out here. Governments and courts have over time, quite rightly, awarded employees extensive rights. Businesses, however, have need from time to time for resources more flexible than can be acquired under terms of employment. There is a whole range of reasons for these needs: the skills needed might be specialised and not part of the client's normal requirements; there may be a project of limited or even uncertain duration; and so on.

In acquiring these skills on a non-permanent basis, companies usually wish to avoid the costs and responsibilities associated with employment. Freelance contractors are prepared to provide these resources as a service, taking on board the concomitant business risks. For this reason, PCG believes, all such contracts should be regarded as business relationships. As this way of working developed, those who entered it were indeed treated as businesses for tax purposes.

The clients gained because they had the flexibility they needed and certainty that they would be free of claims for employment rights. Contractors gained because their companies were taxed appropriately to their status and they had certainty about that status. Clients' employees gained because they could be given their rights without damaging their employers' competitiveness. Government gained because it could award employees such rights without wreaking economic damage and also because these developments gave rise to a more flexible economy than would otherwise have existed.

This healthy situation has been undermined in recent years. The government and HMRC have increasingly failed to recognise that a payment for work can take a form other than a salary. Recent developments in case law, such as the judgments in Dacas v Brook Street (2004) and Cable and Wireless v Muscat (2005) have removed the certainty from clients' position.

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It is extremely important that business to business relationships should be acknowledged and safeguarded both for tax and legal purposes. Some of the developments outlined above will now be considered in more detail and possible solutions considered.

The tax needs of freelance consultants and contractors

The foremost concern of freelance consultants and contractors when considering the tax system is that policy-makers do not understand or appreciate their role in the economy. The notorious "IR35" measure arose directly from this problem: while the consultation paper is right on one level to state that IR35 produced unintended consequences in addition to addressing the original problem (that is, as well as reducing "Friday to Monday" tax avoidance, it penalised a lot of genuine businesses), it could be argued that the government's view that one-person consultancies are shams rather than genuine businesses led it consciously to attack them for more tax revenue.

It remains PCG's position that IR35 should be abolished and replaced with a measure to meet its original stated aims. It puts contractors in a situation whereby their employment and tax status may be determined by a document which they have never seen and to which they were not a party. In the event of an IR35 investigation by HMRC, it typically takes about two years for HMRC even to reach an opinion on IR35 status: PCG's affiliates have handled over 1,000 such cases in which the contractor was found to be outside IR35, and only 3 in which the contractor was inside. If these investigations were conducted consecutively they would last for over 2,000 years: in a self-assessment system, this level of complexity and uncertainty is clearly unacceptable. This is to say nothing of the fundamental unfairness of the tax itself, which taxes contractors as both employers and employees without establishing any employment relationship and without acknowledging that they are in fact in business. A substantial business community exists in the UK which would sit up and take notice of any meaningful political commitment to repeal this dreadful tax.

A more general issue affecting freelance contractors also requires consideration, namely that they do not have steady salaries, but rather consecutive periods with either differing contract rates or, at times, no contract at all. If, for instance, an individual has an income of £60,000 per year and, for simplicity, a tax threshold of £5,000, then over a period of two years tax would be paid on £110,000. If, however, the income fluctuates to such an extent that all the income falls into a single tax year (and many PCG members have reported being out of contract for periods of a year or more) then tax will be paid on £115,000 and, under the Liberal Democrats' proposed 50% tax band, the extra £5,000 will be taxed at the higher rate. One solution to this problem might be to adopt the American system whereby at the end of each tax year, individual taxpayers are allowed an option called "income averaging". If this option is exercised in any given year, then tax for that year is assessed on the average annual income over the last five years. Of course, the individual must have been receiving income for at least five years. This allows people with sharp rises in their income to slow down the rise in the tax they pay. Alternatively, the suggestion on page 25 of the consultation document to tax companies on their cash flows would go some way towards addressing the issue and have the advantage of being a business-specific measure.

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Self-assessment, avoidance and evasion

The current difficulties facing businesses when attempting to self-assess their tax bill have already been touched upon. The corollary of having a self-assessment system ought to be that the authorities overseeing the system assume that the taxpayer is complying unless any evidence emerges to the contrary. Historically, aggressive investigations by the Inland Revenue and a general perception that they were seeking to "get" the taxpayer for as much money as possible suggest that this was not the case. It remains to be seen whether HMRC will assume compliance as standard, but it is PCG's position that any other approach would be indefensible in a self-assessment system.

A clear definition of what constitutes compliance is also needed. The consultation document wrongly conflates evasion and avoidance; they are in fact entirely different, and only the former constitutes non-compliance. Evasion is the non-payment of tax rightfully owed and is illegal. Avoidance is arranging one's affairs to minimise the tax owed and is entirely within the law. It is entirely understandable that the government would wish to counter both evasion and avoidance, but measures to counter the latter must be both unambiguous and fair.

The government's recent anti-avoidance measures have been neither unambiguous nor fair; in at least one case, PCG believes, they have not even been lawful. The attempt by HMRC to reinterpret the settlements legislation retrospectively is being fought by PCG in the courts and the first test case, that of Arctic Systems Ltd, will be heard in the Court of Appeal in November. The Revenue issued new guidance in 2003 which stated that when a company jointly owned by one fee-earner and one non-fee-earner pays dividends to both, the non-fee-earner's dividends must be taxed as the fee-earner's income. It denies to this day, in direct contradiction of virtually all independent comment, that this is a new interpretation of the law, and consequently has been presenting businesses with back-dated tax bills covering six years and typically of just over £40,000. Businesses owned by married couples are commonly susceptible to this measure. Leaving the retrospection aside, this constitutes an annual tax rise for jointly-owned businesses of £8,000 or so. The furore over IR35 arguably persuaded the government not to implement this tax rise via legislation. PCG maintains that this new interpretation is wrong not only morally but also in law, and goes directly against the will of Parliament when it introduced independent taxation of spouses in the 1980s. PCG therefore believes that HMRC should be instructed to reverse its new stance on this matter.

This begs the question of whether a general anti-avoidance rule as suggested by the consultation document would prevent such problems arising again in the future. PCG feels that in principle the idea is sound, but that in practice it would be deeply problematic. The criterion by which financial arrangements would be assessed, namely whether or not their primary purpose is to avoid tax, is difficult to apply: the High Court's ruling on the Arctic Systems case made this suggestion of the company's structure. Yet this is highly contentious: in the case of married couples, businesses are often jointly owned not to avoid tax but because that is what married couples do. Their interests are equally bound up with the fortunes of the company, so naturally it is jointly owned. It is clear from this example that very often HMRC would apply the test incorrectly, which makes a general anti-avoidance rule unappealing in practice.

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Earned income, unearned income and flat tax

The chief virtue of a flat tax system is undeniably simplicity. This does not pertain so much to personal taxation: the current banding of income tax is easy to understand, with only the many available allowances complicating the issue; and one would not necessarily have to introduce a flat tax to remove or simplify the allowances on offer. The real complexity in the tax system has arisen in the area of business taxation.

Reforms to tax company profits at the same rates as personal income would have major implications for freelance consultants and contractors. Such a measure would kill IR35 as an issue, but simultaneously remove an incentive to set up in business. On balance, PCG feels that this merely adds to the considerable number of controversies that would surround the introduction of a "pure" flat tax or any measure approaching it. Overall, the many variables and permutations of a flat tax system make it very difficult at this stage to reach a clear position "for" or "against" it. PCG therefore reserves judgment until details of specific proposals are promulgated; the "double decker" arrangement suggested in the consultation document seems quite reasonable, however.

Further specific proposals

The consultation document raises a number of issues outside the scope of those already discussed which PCG wishes briefly to address. The suggestion that NICs could be rolled into income tax (and employers' NICs rolled into corporation tax) seems entirely sensible. It would make it easier for companies to employ people, would mean complex anti-avoidance measures could be reduced or scrapped, and would reduce running costs in HMRC. The loss of the contributory principle would be controversial, but the lack of any meaningful hypothecation currently attached to NICs could be seen as a welcome development: hypothecated tax is commonly resented by people who do not make use of the service to which the tax is tied.

PCG would welcome reform of the threshold at which businesses have to register for VAT as suggested on page 23 of the consultation document. Removing this obligation from smaller businesses will undeniably save them considerable time and administrative bother and therefore make the prospect of setting up in business less intimidating.

Conclusions

It is vital for all tax policy to take full account of its likely impact on workers who are neither employers nor employees and for new, diverse ways of working to be understood by policy makers. PCG maintains that for a self-assessment tax system to operate effectively it must be both unambiguous and simple and assume compliance on the part of the taxpayer. To this end, IR35 and the new interpretation of the settlements legislation must be reviewed as a priority. PCG will welcome any measures to reduce the monstrous complexity of business taxation, provided they do not unfairly penalise people who have elected to go into business.