

Submission to the Inland Revenue re: IR35

Background

The Professional Contractors' Group (PCG) is a body which represents the interests of a large number of contractors from IT, engineering and other industries. We have been invited to submit a paper to the Revenue by May 21 and attend a meeting with senior officials on June 10. The following submission summarises our position.

Position

PCG welcomed the Chancellor's Budget announcement that individuals who exploit the fiscal advantages of a corporate structure should pay their fair share, when someone leaves work as an employee on a Friday, only to return the following Monday to do exactly the same job as an indirectly engaged 'consultant'. However, the PCG is concerned that the legislation may catch the legitimate contractors who have built up their businesses over a period of time, often encouraged by the Government, and would have a detrimental effect on the knowledge-based industry. PCG wants to work with the Revenue to ensure that these measures are proportionate. Referring to the information revolution, in a recent speech (Feb 99) Stephen Byers, the Secretary of State for Trade and Industry set out the following vision: *"Success in this fast moving world depends critically on how well we exploit our most valuable and distinctive assets: our knowledge-including our world class science and engineering base, our skills and our ideas", he went on..." The real challenge facing this country is how we encourage an enterprise culture in this country."* The investigations we have carried out to enable us to draft this position paper give rise to realistic and genuine concerns about the changes proposed within IR35 with regards to our ability to deliver on this vision.

Main points

The attached submission explains in detail our main concerns, which are summarised here. Appendix 1 provides comments made to the submission paper by our members who in an Internet Ballot to www.pcgroup.org.uk voted 568 to 2 in favour of this submission.

Increased costs - there will be a significant impact on business leading to increased costs and reduced competition; See note 1

Brain drain - knowledge-based contractors would be encouraged to move overseas - and clients may follow - resulting in a reduction of tax revenue; See note 2

Closure of businesses - many small businesses would be unable to operate successfully and would be forced to close, reducing potential employment opportunities for others; See note 3

Flexibility - the proposals do not take into account the typical working methods of the knowledge based sector when the norm is to allow the contractor and client the flexibility to develop the arrangement as the project demands; See note 4

Confusion - the Chancellor's intention is to prevent the so-called Friday-to-Monday problem, however the examples provided by the Inland Revenue are not recognised as realistic scenarios by our members. See note 5

The proposals would assume a contractor is a temporary 'employee' - but there would remain major differences from someone in employment.

Welfare benefit - a contractor who retains earnings to provide for periods between contracts would have to do so from taxed income or alternatively make a claim on the State; See note 6

Training - a contractor will have to fund training - an essential component of the knowledge-based

industry - from taxed income; See note 7

Expenses - it would appear that legitimate expenses such as travel and equipment will have to be paid for initially from taxed income; See note 8

Liability the liability carried by a contractor for his work means that they need to protect themselves through a limited liability company; See note 9

Intellectual property - a contractor may retain rights over their intellectual property which they would lose if treated as an 'employee'; See note 10

Benefits - a contractor does not receive a benefits package associated with employment and makes their own arrangements for pensions and other benefits. See note 11

Conclusion

If the Revenue's real intention is to go beyond the Chancellor's statement and target the majority of contractors, there should be a full **Regulatory Impact Assessment** before detailed and informed discussions can take place. This is in accordance with the Prime Ministers instructions to Ministers and officials as outlined on the Cabinet Office web site, www.cabinet-office.gov.uk. The PCG would welcome the opportunity to assist the Government in this assessment, in line with Dr Jack Cunningham's recent speech (27th April 1999) which called for *'a partnership with the business community as a new approach to regulation'*.

1) Increased costs.

We have identified evidence of significant impact on business and individuals which, without proper consideration, will lead to increased costs and reduced competitiveness for UK industry. From a survey report ^(ref 1) carried out recently, the following points were made:- A non recurring cost of legislation of at least **£188 million**. Recurring administration costs of between **£58 and £115 million** and an increased cost to UK industry of up to **£8.48 billion**

2) Brain drain

We believe that tax incentives provided by our overseas competitors in Europe and the USA (at present not available within the UK) coupled with other factors could lead to movement overseas of: *"our most valuable and distinctive assets"*. The [survey report](#) identified that this potentially would lead to a loss to the Treasury of some **£760 million** due to movement of highly skilled personnel overseas. This movement of personnel putting at risk a further **£57 Billion** of economic activity, at present carried out or directed from the UK.

3) Closure of businesses

Evidence points to possible damage to the admirable aim of encouraging an enterprise culture within our Country. At it's most serious, the legislation will lead to closure of many thousands of small service Companies. Little case study work is available, but the Author of the survey report had built up businesses with sales in the last 6 years of some £100 million as a direct result of the commercial freedom and revenue generated from Contracting through his Limited Company. It would take only **one half of one percent** of other Contractors to repeat this success to generate tax revenues as great as IR 35 is predicting to collect. As has been pointed out, Microsoft started with one employee. This legislation effectively assumes that one man companies are "tax avoiders" whilst larger Companies are "entrepreneurial". The effective requirement for small companies to fund growth from taxed earnings whilst the larger Company is allowed to continue to fund from untaxed earnings is unfair and does not make economic sense.

4) Flexibility

We have identified concerns that the regulations as proposed do not reflect the commercial reality of the way we do business or put another way: "exploit our most valuable and distinctive assets". In the knowledge based sector the demands of technology are bringing client and service provider closer together to work in partnership. This is typified by new methods of working such as Dynamic Systems Development Method or DSDM. (Supported by the Ministry of Defence) One of the main tests that the Inland Revenue use for determining that someone is self employed is the existence of a clear statement of requirements for the work, agreed at the start of the contract with a fixed price. Now consider the following quote from the DSDM web site www.dsdm.org "*Traditional approaches fix requirements (and deliver software which satisfies all of them) while allowing time and resources to vary during development. In DSDM, the exact opposite is true, time is fixed for the life of a project, resources are fixed as far as possible. This means that the requirements that will be satisfied are allowed to change*". This is effectively recognizing in high technology projects it is often impossible to fix requirements (technology/safety issues for example) at the start and therefore difficult to fix a realistic price. DSDM recognizes this and allows the requirements to alter. This is carried out iteratively in close cooperation with all involved. It can be seen that this method of working will suffer a cost penalty caused by this legislation and provide an incentive to clients to utilise outdated methods of working to the detriment of our knowledge based industries.

5) Confusion

We are concerned that the examples put forward by the Inland Revenue do not accurately reflect the current situation. In a recent letter the Inland Revenue gave some examples of typical situations. Looking at the knowledge based examples:-

A draughtsman has for some years been employed by an engineering firm. To reduce his tax/NICs liability and to reduce his employer's costs, the draughtsman's contract of employment is terminated on 28 February and he is re-engaged on 1 March to do the same work on similar terms via a personal service company. The draughtsman is subject to ongoing control as to what tasks he undertakes and how they are carried out. This arrangement should be caught by the new rules. In the survey this applied to only 4% of Contractors.

A local council engages a firm of architects to design a new Civic Centre. Within the terms of the contract the architects must provide three different designs within an overall budget. There is a minimum requirement for office space, amenities, public areas etc. The designs must be completed within a fixed time-scale. The contract details the work to be carried out, timing, specification etc. These issues are agreed at the outset and the council do not subsequently have the right to tell the firm what tasks are to be undertaken e.g. they cannot tell them to design something different without amending the contract. Beyond the contract specification, the Council has no control over how the firm carry out the work. The new rules should not apply here. This traditional contract is not typical in high technology areas, see reference to [DSDM](#) above.

An IT engineer employed by a medium sized manufacturing company decides to 'go it alone' - leaving employment to set up his own IT consultancy. A few weeks later the former employer engages the consultant to undertake a millennium bug health check on all the company's computer systems. The consultant negotiates a fixed fee for providing a specified service to a pre-determined deadline. The company has no ongoing right of direction or control over what is done or how it is done. The new rules should not apply here This was not recognised by many of the IT consultants. This would be the equivalent of the MOT check carried out by your garage, not the subsequent repairs to the resulting problems. It may be carried out, but the commercial value of such a contract is insignificant compared to any subsequent work, which will normally be carried out on an hourly "cost plus" basis.

A travel company has had a new computer system installed. The company hires an IT consultant to supply additional technical support and training for staff in the use of the new system. The consultant is taken on for a period of three months to undertake tasks as directed on a day by day

basis by the IT manager. The new rules should apply here. In the survey only 11% were help desk/support.

6) Welfare benefit

Unlike employment where an individual has a reasonable expectation of continued employment the Contractor through his Limited Company has to make provision for periods between contracts. Over 88% were retaining earnings and this has resulted in extremely low take up of welfare benefits (only 1% in the last 2 years have claimed any benefit) The legislation would require him to make this provision from taxed income and at the same time provide him the "incentive" to make claim upon the state. Older members find it especially ironic that having been denied a job in the "employment" market because of their age and having made every effort to support themselves and their family without recourse to the State that they should be classed as "tax avoiders" working in disguised employment.

7) Training

The person in permanent employment has training provided by their Company effectively tax free. The legislation will force the Contractor to provide for this, (in a sector with knowledge obsolescence reported at 20% per annum) from taxed income.

8) Expenses

The person in permanent employment has their travel expenses met by their company, often having the benefit of advances to ensure no negative cash flow. The Contractor, under the new legislation, will have to meet ,often substantial expenses due to the high mobility requirements, from taxed income and then rely on claiming back such tax at a later date.

9) Liability

An employee will have no personal liability for work they carry out. A contractor will be liable for errors. The potential downside on some projects makes it essential that they protect their assets through a limited Liability Company.

10) Intellectual property

An employee will have no claim over the intellectual property that they may create. A Contractor, unless agreed to differently, will own the rights to their know how and intellectual property. This allows for Capital growth in their Company over and above the simple provision of services. As many Client Companies are owned from overseas it crucially allows for the retention of Intellectual Property within the UK.

11) Benefits

An employee, especially in an area of scarce resources such as IT and engineering, will have a benefits package to enhance his basic pay. This may include a pension scheme to which their employer may contribute significant tax free sums. A Contractor makes their own arrangements (76% surveyed were operating a company pension scheme) A result of this is that they must pay a good salary (and therefore Tax and NI) to ensure reasonable pension payments.

Ref 1 ["Survey to investigate the impact of planned changes to the tax regime affecting service Companies working in the knowledge sector, specifically IT and engineering"](#) Internet survey carried out by engineerjob.com Ltd. Report dated 16/5/99. Ref 99/025_003