



Patron: the Rt Hon the Lord Weatherill DL

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9 September 1999

Ms S Walker  
Inland Revenue  
New Wing  
Somerset House  
LONDON  
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Dear Ms Walker

### **IR 35**

I am writing in response to recent press reports that your Treasury Minister, Dawn Primarolo has held one or more secret meetings with various representative bodies to discuss your latest plans for IR 35 legislation.

#### **Consultation**

Firstly, the Professional Contractors Group ("PCG") is extremely concerned that the "consultative process" you are engaged in does not represent proper consultation as set out in the better government guidelines. Please correct me if I am wrong but, as I understand it, the meetings held last week did not include any representation from any body which can validly claim to represent the many knowledge-based contractors in the IT and engineering sectors who will be affected by the IR 35 legislation? Those present largely represent end users, the accountancy and tax professions and large international software and consultancy businesses. While all of these have a legitimate interest in IR 35 they do not represent the contractors who stand most to be affected by any changes.

No one from the Professional Contractors Group was invited. I believe that the PCG is the only body who can legitimately claim to represent the interests of the knowledge-based sector of the contracting market. As IT and engineering contractors constitute the largest group of contractors in terms of their economic impact we do not understand how a consultation process which ignores their representative body can be said to meet the conditions which the Government itself has set up for better government and better legislation.

The PCG has repeatedly volunteered to work with the Government in drawing up effective but proportionate legislation. We accept that the legitimacy of the Government's originally stated objectives of

- safeguarding the rights of employees and
- stamping out artificial employment arrangements set up to reduce the amounts of national insurance being paid by employers and the amounts of tax and national insurance paid by their employees.

Nevertheless our offers have not been accepted and it appears that you are intent on progressing the legislation without affording those most affected the opportunity of assisting in the development of the new rules.

In addition it appears that, both in drawing up the proposals in the first place as a response to lobbying by specific large businesses and, in your subsequent actions, you are intent on producing legislation which favours large international companies - some of whom are already the beneficiaries of valuable contracts with the Inland Revenue - at the expense of small UK entrepreneurs.

### **New proposals**

It is our understanding that your latest plans involve dropping the proposed registration/certification of agencies and the use of the control, supervision and direction criteria and will fall back on the application of the broad range of tests for employment versus self -employment.

### **Certification/registration**

We would welcome the dropping of the registration process. It removes yet another potential burden on small businesses and, as the current problems with the construction industry scheme have shown, any such process is fraught with practical problems. However, the issue of who bears responsibility for paying the PAYE and National Insurance in situations of deemed disguised employment needs certainty. Under the certification proposals, provided the personal service company (PSC) was properly certified/registered, the end user was absolved of any responsibility in the event that the PSC failed properly to account for PAYE and NIC. End users and agencies need assurances as to their responsibilities should a PSC subsequently prove not to have applied the new rules properly.

However, if it is envisaged that the PSC will bear sole responsibility for the proper adherence to the new rules there needs to be clear guidance on what sanctions will be taken against a PSC which is deemed not to have applied the rules correctly. Situations will arise where a contract has been agreed by all parties as being one of self employment but subsequently the Inland Revenue may challenge that position. PSC's should not face possible penalties for legitimate differences of interpretation in what is a very complex area.

### **Employment versus self employment**

We previously expressed great concern about the relevance of the supervision, direction and control tests to the current working practices of knowledge-based contractors. These concerns remain equally valid if the proposals are now to fall back upon the use of the full range of tests for self employment versus employment. These traditional tests are largely derived from old master/servant traditions and the work practices of the industrial age. They do not reflect the realities of modern knowledge-based commercial practice. Tests such as direction and control, mutual obligations, integration, provision of equipment, rights of substitution etc. are increasingly difficult to interpret and apply to the knowledge- based contracting sector.

For example, where a client has a project in an area requiring large amounts of intellectual "capital" - i.e. the design of a ship/plane/car/IT system - what are the human resource options?

1. Taking on permanent staff would be wrong if the client would be unwilling to meet the employer's obligation, established in *Hellyer Brothers Ltd v McLeod* [1986] ICR 122, of offering "continuing employment to the alleged employee".
2. Specifying the work to enable a fixed price bid to be invited may involve several problems
  - 2.1. The client may not have the time, resources or expertise to carry this out.
  - 2.2. The technical issues and risks may make this route commercially unacceptable as any price will have a large premium to take account of this risk.
  - 2.3. The client may require close integration with his own core team of staff and a fixed price relationship will often be detrimental to this.
3. Increasingly in the knowledge based industries a client turns to a cost plus route, that is payment for time worked. Other features of this commercial relationship often include:-
  - 3.1. The client will require the consultants to work on site and integrate closely with his own team, as such they will be expected to keep similar hours to his own staff .

- 3.2. Frequently the client will opt to manage the technical risk in the project. They will normally retain design approval (control) and often limit the liability of the consultant working on the projects. They may not be required to correct their mistakes, as the liability/ downside on some of these projects will be enormous.
- 3.3. Work will be carried out on the client's own computer equipment and software as problems with virus/network interconnectivity and compatibility make it impractical for the consultant to bring their own "tools".
- 3.4. Although budgets will have been set, safety or technical issues may prevent a bonus being paid for early completion. In addition, because the meeting of targets by the consultant may be dependant upon the performance of the client's own staff, it is often impractical to structure arrangements in a way which enables the self employed consultant to be rewarded for sound management.

To carry out this work the client could utilise the services of a full service design/software/consultancy house to manage the problem. However this will incur a premium, maybe double that of the small company, to support the larger overhead structure. Increasingly, therefore, the client is subcontracting the work to a number of consultants working through their own companies, often with one employee, who may, themselves, sub contract the marketing of their skills and the collection of their fees to an agent.

Issues such as these will make the legislation very difficult for anyone involved in the knowledge based sector to apply with great certainty. As the Revenue's own manuals note in their discussion of the issue of employment versus self employment, many of the standard criteria are not conclusive and have been subject to various interpretations by the Courts, when applying them to specific situations.

In practice it is likely that many knowledge based contractors, who operate under conditions which meet the self employed criteria will, nevertheless, be unable to afford the risk of a challenge by the Revenue and the professional costs involved in responding to such a challenge. They will, therefore, be forced to adopt the rules for employed contractors. We do not believe that this Government would seek to bring into force tax legislation which is so complex or subjective it intimidates people into foregoing their rights through fear of making a mistake.

Presumably any changes will involve the provisions of s134 of the ICTA 1988 relating to agency workers. Currently these provisions include specific exemptions for certain categories of worker such as actors and musicians. Presumably it will only be equitable if these exemptions are now revoked and these categories of worker made subject to the same rules?

### **Changing existing professional practice**

The application of the full employment/self employment criteria to all personal service situations will also call into question many established practices in professional service firms. For example, if a partner in a firm of accountants is asked to substitute for a client's finance director when the director is absent for an extended period through illness, a common practice would be for the firm to bill the client at an agreed rate and for the fees to be treated as a normal part of the practice's fee income. Strict application of the rules may well indicate that the partner is now in disguised employment with his client. Would you now require these fees to be treated as income which is subject to PAYE and national insurance and, if so, how would the proposals for expenses be applied?

Similarly, many accountants in practice routinely provide management accounting services to small businesses under conditions which could well be interpreted as failing the self employed tests and therefore being employment. Is it really your intention to drag these situations into the employment net?

### **Practicality**

We also question the practicality of how the Revenue will enforce the new rules. In order to establish if the rules have been properly applied the Revenue will need to examine each personal service company in detail, especially the nature of its contracts with its customers.

This may become more difficult if, as is likely, the typical contracts between clients, agencies and contractors change to better reflect the characteristics of self employment. This will mean that a mere examination of the contracts will not necessarily establish the full nature of the relationship and the Revenue will be forced to clarify the facts of the situation by a detailed investigation of the actual practical arrangements which subsisted at the client's premises.

Bearing in mind also that all of this will be taking place at least 9 months after the close of the PSC's financial year, which may be nearly two years after the contract arrangements were in force, it is likely that this will significantly increase the costs of implementing the rules for the Revenue. It will also lead to considerable additional costs for the many businesses which engage in providing personal services on a self employed basis. The likely outcome is that the Revenue will adopt crude unofficial guidelines for levels of salary versus dividend income, which may result in many "employed" contractors working to the very edge of the parameters, while those who are in valid self employment bear the brunt of the Revenue's investigations

This does not seem to be a fair way of administering the tax system nor is it likely to produce the level of additional revenue predicted by the Welfare Reform Bill's RIA. It will also certainly result in more implementation costs than the derisory figure of £55,000 in year 2001 that was quoted in the RIA.

### **Expenses**

We also understand that the new proposals may allow for contractors to claim up to 5% of gross income as expenses. This raises important issues that need to be clarified. One area of expense that can be very material for many contractors is travel costs. Under the travel expense rules introduced from April 1998 many contractors are able to claim the costs of travel from home to their client on the basis that they are working at a temporary place of employment under arrangements which are not expected to persist for more than two years. A blanket rule of 5% appears to preclude the continuation of such provisions. Do you envisage that the new rules will remove contractor's ability to claim such travel expenses on the grounds that they are to be regarded as being employed by their client at the client's place of business?

Many contractors work considerable distances from their homes and can only afford to do so because of their ability to claim their travel costs. Any changes to this situation could have a significant impact on labour flexibility and the ability of businesses to secure the services of the highly skilled IT and engineering contractors they need to develop new projects.

### **Abuses**

Another concern is that the new proposals still do not appear to address some of the abuses noted in IR 35. Most commentators, ourselves included, agree that the use of composite umbrella companies is wrong. These are usually just a vehicle for enabling businesses to reduce costs by creating an artificial arrangement into which existing employees are forced to enter. Nevertheless there is nothing specific in the proposals which addresses this issue.

Similarly there appears to be little in the proposals that will ensure that contractors from overseas, working in the UK for only a year or two, abide by the rules and pay their fair share of tax and NIC. If they abuse the rules they may well escape the net before the system catches up with them.

There is also nothing which specifically addresses the Friday/Monday syndrome - again another area where we would be happy for action to be taken, albeit that we believe the situation is less common (certainly amongst engineers and IT specialists) than is claimed.

### **Self regulation**

The PCG agrees with the Prime Minister's view that self regulation is more desirable than additional legislation. We sense from discussions with many of the other representative bodies that the various parts of the industry are willing to set in place appropriate elements of self regulation that could, for example, restrict the use of composite umbrella companies. We would welcome the opportunity to discuss how this could be put effectively in place and to enter into meaningful consultation with you to produce rules which are cost effective to

operate and which target real situations of disguised employment and the denial of employment protection to real employees.

### **Conclusions**

As you can see from the above points we are very concerned that any new rules developed without proper consultation will prove ineffective at achieving the stated objectives, cumbersome and costly to operate and disproportionate in their impact on businesses that should not have been affected by the rules. We must also reiterate our previously stated views that:

- Voluntarily leaving employment to take on the risks of selling your knowledge on the open market is not disguised employment. It falls squarely within the definition of self employment as “anxious to be employed for the purposes of gain”.
- The majority of IT and engineering contractors do not work in “disguised employment” and are entitled to arrange their affairs in a way which takes advantage of the distinctions embodied in company law and tax legislation between individuals and companies and between employees and investors.
- Tax avoidance is not illegal or immoral. It is a legitimate exercise that all tax payers are entitled to adopt. Rewarding yourself by dividends rather than salary is an option open to all company owner/managers and is not tax evasion.
- Knowledge-based contractors need to be able to retain reserves in their companies in order to invest in new projects and further training.
- The use of self employment tests for the knowledge-based sector is flawed.
- Engineering and IT contractors have a long history of extending their entrepreneurial activity beyond contracting into new areas, which will be seriously jeopardised if the rules are not carefully thought out after proper consultation.
- The IR 35 proposals appear to favour large international consultancy companies at the expense of many small UK based entrepreneurs.

If the eventual outcome of the IR 35 process is not fair, balanced and workable its impact on this country's competitive edge in the deployment of knowledge-based workers will be put at risk - with serious implications for the future development of our economy and its competitiveness in the European and world market place.

Yours sincerely

Kevin Miller MA, FCA

For and on behalf of the Professional Contractors Group