PCG
professional
contractors group

Grahame Horgan
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Dear Mr Horgan

A REVIEW OF COMPETITION RESTRICTIONS IN THE PROFESSIONS

We are responding to the request for comments in the above Consultation Document. We note that, although Ministers have asked the Director General to focus the review upon the "more economically significant professions" including lawyers, accountants and related professions such as auditors and insolvency practitioners, the review may "also include other professions of particular economic significance".

Background

The Professional Contractors Group has over 10,000 members who are involved in knowledge-based consulting activities, mainly through the medium of small limited companies. Our members are drawn mainly from the IT and engineering professions but also include qualified accountants and others involved in a variety of consulting or interim management activities. With typical turnover in the range of £50,000 to £100,000 and some with sales greatly in excess of that range our members represent businesses with a combined turnover of at least £750 million. Our members also represent about 10% of the total knowledge based contracting/consulting market so their concerns are representative of small businesses with a turnover that may well approach £7.5 billion. As such we consider that we represent a professional group that is highly "economically significant".

We recognise that your review is aimed mainly at considering issues relating to:

- restrictions on *entry* to certain professions;
- *demarcation* restrictions, reserving categories of work to certain professionals; and
- restrictions on the *conduct* of regulated professionals we also note that in paragraph 17

but we also note that you state that:

"The scope of the current review is not limited to the identification of restrictions which have their origin in professional rules or conduct[1]*. The review hopes to highlight* ***significant restrictions whatever their origin.*** *Thus, we are interested in learning of restrictions which have their origin in conduct of third parties. This might include situations where a third party will only accept the services of a certain category of professional and imposes this restriction upon clients and practitioners.* ***We are also interested in identifying restrictions which originate from national or Community law."*** (our emphasis)

The PCG believes that its members, and small contractor/consultant businesses in general, face very severe restrictions stemming not from the activities of professional bodies but from the actions of the Government itself. Our concerns are set out in the sections below.

"The provision of services through an intermediary" – IR 35

In the March 1999 budget the Chancellor announced that he proposed to take steps to change the basis of taxation for individuals who provided their services to clients through an intermediary company or partnership. These have become known as the IR 35 proposals, which take effect from 6 April 2000. The initial proposals of spring 1999 were replaced by new proposals in September 1999. These have now resulted in new legislation, the first of which is the Social Security Contributions (Intermediaries) Regulations 2000, which came into effect on 6 April 2000. This puts into effect changes relating to National Insurance legislation. The corresponding tax provisions are being effected through schedule 12 to the Finance Bill 2000 currently going through Parliament.

The broad thrust of the legislation is to attempt to identify whether a worker, providing their services through an intermediary, would have been an employee of the client or a self-employed person had the intermediary not existed. The legislation uses the criteria developed through case law over many years. Contractor consultants, who are deemed by the Revenue to fail the tests, will be required to pay income tax and employer's and employee's National Insurance on 95%
of their gross income.

Since this legislation applies principally where a consultant has a significant interest in the company providing his services or receives rewards in forms other than salary, it will

[1] In this respect, the duties of the Director General under FTA Section 2(2) are broadly defined. He keeps under review the carrying on of commercial activities within the United Kingdom with a view to becoming aware of or ascertaining the circumstances relating to monopoly situations or uncompetitive practices. Under the FTA, the term "uncompetitive practice" is broadly defined to mean "practices having the effect of preventing, restricting or distorting competition in connection with any commercial activities in the United Kingdom". "Practice" means "any practice, whether adopted in pursuance of an agreement or otherwise."

not affect the larger (often international) consultancy companies such as EDS and Andersen Consulting, which provide consultants in competition with PCG's members.

We consider that the IR35 legislation represents a barrier to entry into the knowledge-based consultancy market, restricts the provision of consultancy services through small independent companies and, consequently, reduces competition and limits the choice of the clients using such services. This new legislation is, therefore, deeply restrictive and anti competitive for two principal reasons.

Uncertainty

Virtually all consultants who work through a small company or partnership and who tend to work for only one or two clients at a time face considerable uncertainty as to their tax status. A feature of the case law, from which the critical employment and self - employment criteria have developed, is that these criteria are constantly being refined and re-defined. Hence new developments in working practice such as the growth of outsourcing tend only to be recognised in tax practice once new case law has been developed.

Added to this is the fact that, as a result of pressures from tax law - for example section 134 ICTA 1988, consultants who might otherwise have operated as self-employed individuals have, instead, been forced to work through small companies. In these circumstances their employment status has not been challenged. Hence there are few recent relevant tax cases that can be said to have clarified the current application of the employment and self -employment criteria.

This means that many consultants operating through small companies and partnerships are uncertain, from contract to contract, as to whether their activities will be caught by the new rules or not. This is a totally invidious position for anyone operating a small business. They find it very difficult to make any assumptions about future profitability, tax liabilities, cash flows or investment.

This level of uncertainty will create a restriction to entry for professionals wishing to enter this marketplace. Unable to ascertain their tax status they will be put off starting their own business selling their knowledge. This will reduce the start up of competitors to the existing larger Consultancies

Uncompetitive

If an engagement is deemed to fall under the new rules the small consultancy company is permitted to deduct only those expenses that any employee can claim (for example travel to a temporary workplace), company pension contributions and a final round sum allowance of 5% of gross fees.

The balance is deemed to be salary of the consultant for tax and National Insurance purposes. In these circumstances there is no scope for the small consultancy to retain

profits for future investment, or to cover the costs of periods with no fee-paying work. It also means that the company has to fund the costs of training or research out of the 5% allowance or out of taxed income. Similarly the salaries of any non fee-earning support staff (and the related employer's NI) would also have to come out funds already taxed as the income of the consultant. This would include for example, in the case of a small software house, staff developing software products for later sale.

Despite the fact that the consultant is effectively taxed as an employee of the client, he will receive no employee benefits from the client. These will still have to be provided by the small consultancy company. This places the small consultancy at an competitive disadvantage compared to a large consultancy to which the rules will not apply.

For example consider a typical example (from a real case study) of a consultant working for EDS, which provides IT experts to carry out specialist tasks at a client. They charged him to clients at £700 a day and paid the consultant a salary amounting to £100 a day. They made a gross profit of £600 a day out of which they paid employer's NI on the consultant's salary. EDS was free to use this to invest in research, to improve the corporate marketing, to employ support staff to deal with the administration related to employing staff, to fund sickness insurance for the employee and invest in his training programme etc. The net profit could be retained for future investment or paid out as a dividend to the company's owners.

The consultant left and set up his own company to provide his services on similar terms. He pays himself the same salary as he received before (and therefore paid the same NI and PAYE on it), but charges only £240/day to his clients. From the fees earned he invests in hardware and software, in order to train himself in new areas like networks and the Internet. He also takes dividends from the taxed profits, on which he pays additional higher-rate income tax.

However, under IR 35 based on criteria such as working at the client's site, using client equipment, and being required to work normal working hours alongside other staff and consultants because of the nature of the project, the consultant working for himself may fail the IR 35 tests while the EDS consultants working alongside him will not even be subject to such tests.

As a result of failing the tests the consultant working through his own company will have to pay employer's NI and PAYE on almost all of his fee. He cannot reinvest for future growth. He must cover the costs of training or sickness out of his own taxed income. None of these restrictions apply to the large consulting company.

Fast Track Visas

In addition the recent introduction of Fast Track visas will worsen the situation. There is evidence that the major consultancy companies will be able to bring their own employees into the UK using the fast track procedures and that the favourable tax status

awarded large consultancies, coupled with their ability to access resources from anywhere in the world, will be used to drive their smaller competitors out of business.

In an article published on the Shout 99 web site a contractor has reported that one large consulting company is now charging its UK client £75,000 for each consultant it supplies. However, using the fast track processes they are fulfilling that contract by recruiting Indian IT consultants and are allegedly paying them £12,000 a year. The difference is used to pay costs; travel, admin, marketing, accountancy etc., and to build reserves to allow the company to invest in training and provide a contingency fund for periods between contracts as well as delivering a profit to the shareholder, *who in this case is a different person from the worker.*

Apart from the Indian consultants, who are employed by the large consultancy, there is another who is an employee of a small firm in which he happens to be a major shareholder. These consultants all work alongside other workers who are paid directly by the client. They all sit together in the client's offices. They are all under the supervision, direction and control of the client, and work for fee, usually based on an hourly or daily rate. As a result they could all be classified as a disguised employee under the IR 35 "self employed" tests. However those rules will only apply to the consultant who works for his own small company.

The client is currently paying £88,000 to this consultant and his company is in turn paying him £12,000 in salary. The difference is used to pay costs; travel, admin, marketing, accountancy etc., and to build reserves to allow the company to invest in training and provide a contingency fund for periods between contracts as well as delivering a profit to the shareholder*, who in this case, is also the person doing the work.*

Under IR 35 this company and it s shareholder is now considered to be unfairly avoiding tax and is required to tax 95% of the turnover as if it was a salary. The consultant is not able to retain any money within the company. He cannot build reserves to invest in training. If he trains in the wrong skills he takes the risk, not the client. If as a result his skills are not in demand it will be his company that pays his wages, not the client. If he wants to take a holiday, it is his company that pays. If he becomes sick it is his company that pays. If he wants to take advice on his contracts to meet some new and complex tax rule, it is his company that pays. All from taxed income.

The large consultancy is treated as a genuine business, is taxed accordingly and consequently suffers no such disadvantage. As such they can compete more effectively against the smaller company. As a result the UK client is now threatening to terminate the contracts of those consultants who are owner managers saying that the large multi-national consultants cost a lot less.

This can only be described as anti competitive and discriminatory and against the broader interests of the UK economy. Why should new consultants setting up business on their own and initially dependant on perhaps only one client be expected to incur the risks of setting up in business on their own account without being able to enjoy any of the compensatory benefits of their risk taking?

In the Government's own regulatory impact assessment of their proposed legislation they forecast that the new rules would result in up to 66000 small businesses closing under the weight of the additional taxes. Many of these are all small companies that aspire to growing larger as they offer effective competition to their larger competitors. IR 35 will unfairly impair their ability to compete.

Conclusion

The introduction to your Consultative document states:

The customers of United Kingdom professions need from the professions an appropriate choice of services, provided efficiently and to a high standard. The professions must be competitive, unfettered by unnecessary restrictions and free to adopt the business structure best suited to meeting clients' needs.

The PCG believes that these aims apply in full to the provision of knowledge-based consulting/contracting services within the UK.

IR 35

- presents a barrier to entry into the knowledge-based consultancy market,
- restricts the provision of consultancy services through small independent companies
- reduces competition and limits the choice of the clients using such services.
- represents an unnecessary, unwarranted and unfair restriction on the ability of knowledge–based workers to adopt the business structure best suited to meeting their needs and those of their clients.

Yours sincerely

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