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The Beginning of the End or just The End of the Beginning?

Now that the Office of Tax Simplification has produced its interim report to the Chancellor we look at the key messages and possible outcomes.

The terms of reference given to the OTS by the Chancellor on IR35 were;

- Provide evidence of the uncertainty and complexity created by IR35
- Consider alternative legislative approaches that would be simpler and create certainty while ensuring employment income is taxed fairly
- consider the impact of the alternatives on tax avoidance

with a series of further principles that were to underpin and guide any recommendations made:

- build consensus amongst small businesses, tax professionals and academics;
- take into account current and emerging trends amongst small businesses;

- consider all HMRC taxes and duties that impact on small businesses, including the administrative burdens imposed;
- take into account Government objectives for labour market flexibility;
- be consistent with the principles for a good tax system, including fairness and efficiency;
- be broadly revenue neutral overall

Any recommendations put forward by the OTS had to meet these principles and objectives.

Provide Evidence

After 10 years of IR35 and all the lobbying carried out you would expect detailed research and evidence supporting the arguments for change; unfortunately this was not the case.

Whilst Professional Passport provided the full data reports of the surveys we had carried out there seemed to be little hard data on the whole area of IR35.

One of the guiding principles was to ensure that any recommendations were “broadly revenue neutral” so the obvious question was - how much revenue is currently being collected through umbrella companies, contractors who apply IR35, compliance activity, and those who fall outside IR35? The only data available was from compliance activity which had generated £9.2 million of additional revenues in 5 years, less than £2m a year as a result of all the compliance activity.

Understanding the size of the market, and therefore being in a position to assess any wider impacts also seemed a key aspect;

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once again there was little if any reliable data available.

HMRC data collected from companies P35 submissions for tax years 2007/08 and 2008/09 showed that 70,000 - 75,000 businesses declared themselves as service companies with 30,000 of these confirming they applied IR35 or MSC legislation in 2007/08 with the number declining to 9,500 in 2008/09.

In the absence of hard data to support arguments either way it was clear that significantly more work and research was required to find the right outcome.

This lack of hard data could help to explain the comment on the first page of the report by the Rt Hon Michael Jack;

"Of all the topics we tackled this proved to be thorniest. It encapsulates the tension between HMRC, who are tasked with applying the tax code in order to protect and gather revenues, and individual businesses who see IR35 as a barrier to them running profitable small enterprises with all the risks that this involves."

What is clear is that no one method of reform currently commands universal support. It is also evident that any future decision on, for example, abolishing IR35 altogether would require underpinning by a much better quality of data than presently seems to be available."

The first positive outcome

An acceptance that the contracting market is not understood and before important decisions are made a much better understanding of the market must be achieved; this must include access to quality hard data and evidence.

This in itself is a major step forward for the sector as many of the

burdens and bureaucracy currently in existence were built on no more than perceptions with many of these being wrong.

The second positive outcome

I have lost count of the number of emails I have sent to various ministers and Government departments as a response to a comment that contractors incorporate for tax motivated reasons. For too long now this perception has been allowed to grow and develop unchecked resulting in this thinking underpinning much of the legislation in force today.

As a direct result of the OTS work significant inroads have been made to change this perception with an important recognition in the report stating:

"the motivation to incorporate is driven by the end client as protection from PAYE risk and the avoidance of employment rights; the agency rules in ITEPA 2003 s44 are also a factor"

With new legislation coming into effect in October this year there are likely to be further incentives for end clients and recruitment companies to encourage contractors to incorporate.

The third positive outcome

Our work over the last 4 years has been based on the fact that the contracting market is a wide and diverse population with many different objectives; for this reason we have passionately fought against the old approach of "one size fits all".

Over the last 10 years we believe the market has grown and developed in to a size that requires a segmented approach to legislation; with specific legislation aimed at specific sectors.

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Provider Compliance

Our audited and approved accountancy service providers have all been checked against the MSC legislation.

Our audited and approved umbrella providers have also been checked against appropriate legislation.

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The OTS are clearly keen to more fully understand the market and therefore we feel there is a greater chance that legislation will be applied in a more specific way. It is also encouraging to see this fact reflected in the body of the report:

"the population affected by IR35 is extremely diverse and an alternative to IR35 that uses a 'one size fits all' approach is unlikely to work."

Build Consensus

This aspect was always going to be one of the major challenges for the OTS with so many strongly held views and opinions; not just within the committee but the wider population; and with a lack of available data to support any particular argument people were always going to push for their favoured option.

What created a further layer of complexity, that the process could have done without, was where the spoken and private word of some was in direct contrast to their written and public position.

If the Chancellor feels that further work and evidence is required we would suggest that it is essential that all involved parties operate in a clear and transparent way, private and public positions should be aligned. Without this there is a danger of future processes being hijacked for purely commercial reasons.

The specific suggestions made in the report

The report makes three alternative suggestions as to the way forward:

1. Suspend IR35, with a view to abolishing the legislation permanently

2. Retain IR35 legislation in its existing form but with explicit commitments from HMRC to make specified changes to enforcement

3. A Business Test

Suspend IR35 with a view to abolition

Suspending IR35 with a view to abolish is a complex suggestion with wide reaching short term impacts.

Whilst some would suggest that suspending IR35 would have little impact on umbrella companies we would disagree strongly and the evidence we have collected from the sector suggests our position to be correct.

MSC legislation prevents the wholesale shift from umbrella to limited company however it is still highly likely that many contractors would make the move to incorporation if the risks of IR35 were removed.

The suggested review on the merger of tax and National Insurance has been a cause raised on many previous occasions with many reports supporting both sides of the debate.

Analysis of the points made in the review should sound some clear warning bells for contractors operating through their own limited companies:

Dividend versus salary - we highlighted this as an area that may be focussed on if the agenda to abolish IR35 was progressed. The danger here is that everyone could be worse off, not just those currently affected by IR35 - which as the numbers show is a very small amount of the market.

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Employment Status - looking to equalise tax and NI across both the employed and self employed is a complex, and we suggest, flawed argument as it only looks at one aspect of the equation.

Whilst a self employed worker and employed worker pay the same levels of tax the National Insurance Contributions vary significantly. A self employed worker is subject to 8% whilst an employed worker is subject to 23.8% when the employer costs are also considered. Looking at this in isolation does suggest an imbalance although when looked at in the round; taking account of all the tax measures available it seems to balance.

A successful company director can select what, if any, salary they wish to take and this is deducted as a business expense therefore reducing any corporation tax on the profits. Once corporation tax on the profits has been paid the director is able to take a return on investment through dividend payments that are not subject to National Insurance.

When compared to the overall tax position these numbers can be flexed to deliver a similar position overall.

If the suggestion is to consider aligning employee and self employed pay then this breaks an important fundamental of recognising and rewarding the entrepreneurial spirit that exists within UK Ltd.

Entrepreneurs and anyone wishing to establish a business take significant risks and therefore should have tax incentives in place to encourage them to take that risk. This has always been the case and has served the business world well over many years.

The only possible reason to change this where it relates to contractors is where the suggestion is that they are not taking risks.

Whilst a contractor at outset may know the details of their first assignment the contracts often have termination clauses that can allow that assignment to end at any time and with relatively short notice periods. Furthermore a contractor has no certainty of future work and so we would suggest takes all the same risks as any other small business entrepreneur.

What we do accept is that the issue of employment status, in so much as the line between employed and self-employed needs to be more clearly defined.

Over recent years, and partly due to IR35 case histories, the line has become blurred.

Employers and contractors both seek clarity around this aspect and achieving clarity will provide a platform for the growth and expansion of the flexible workforce in the UK.

Choice of legal form - It has always been an individual business' decision on the operating structure that best suited their needs. These decisions were based on a wide variety of reasons ranging from protection against creditors, tax position, simplicity of operating, finance and banking options to name a few.

The only area that this has not held true is the contracting sector. The Government removed that freedom of choice with the previously mentioned changes to legislation and forced contractors to operate through their own limited companies regardless of their preference. Interestingly enough prior to this rule the majority of contractors operated as self employed individuals.

Why was it considered necessary in the 80's to make this change?, Do the reasons still hold true today?

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It is now down to the Chancellor to decide his preferred options and direction going forward. What we believe is clear is that this is just the start of the journey and the final destination is still some way away.

**Read the full OTS
Report here**

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and if that one rule was reversed what impact would that have on the market?

Allowing natural forces to drive the shape of the market has served the Country well for many years and we would suggest could do so for many more years.

Whilst there maybe reasons for new structures or simplification the concept of allowing market forces to prevail should continue; any manual interventions removing this flexibility should be removed.

Retain IR35 - there are many reasons why this option could now be the favoured route;

"the risk of an IR35 investigation by HMRC, in simple statistical terms, is minimal"

Something that most contractors have known for sometime.

The number of investigations being reported has reduced dramatically over the last few years and with cuts in the budgets of HMRC departments this is unlikely to change.

IR35 is costly to enforce, and if the figures are to be believed they suggest that compliance activity returns less that it costs to enforce; not a strong model for the future of active IR35 enforcement.

With the new Agency Workers Regulations coming in to force later this year there are more reasons for contractors to incorporate as this will become the operating structure of choice by recruitment companies and employers.

This does present an issue for lower paid or short term workers although umbrella could still be an option as well as operating through the agency's own PAYE.

Certainty - the feedback from most contractors was that they wanted certainty; this is where the idea of the business tests came from.

Professional Passport, FCSA, PCG, IOD and many others were in broad agreement that whilst it was not simplification it could provide short term certainty on status for many contractors concerned with the threat of unexpected tax bills.

What proved less straightforward was the design and agreement of the tests.

Summary and conclusions

It is now down to the Chancellor to decide his preferred options and direction going forward. What we believe is clear is that this is just the start of the journey and the final destination is still some way away.

The opportunity to influence the future direction still exists and we would encourage transparency and openness in the future processes.

We will of course look to be involved in any future projects. We will continue to gather data through our surveys and research and continue to seek the views of the contracting community.

Whilst the answer to the IR35 is still not clearly defined there are many positives that contractors should take from the work so far.

We will of course be keeping a keen eye on the budget and update all our readers as a matter of urgency.