

Office of
Tax Simplification

Small business tax review

March 2011

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Foreword

Some months ago, the Chancellor waved the OTS off as it set out on its journey of exploration into the world of small business taxation. Our map for the journey was something akin to the broad outline given to explorers of yesteryear as they set off for the South Seas. We had a brief to “examine evidence, recommend priorities, consider their impact and produce an interim report”. Well, we have had an interesting journey - one that is not yet over - and we have stuck to that direction.

In presenting the findings from our interim report of small business taxation, we recognise that the old maxim of “you can’t please all of the people all of the time” will apply to the content of our report. This position reflects the fact that in this area of tax reform, each proposed solution attracts passionate and well informed supporters’ clubs. So it will come as no surprise that the Office of Tax Simplification (OTS) has not been short of information and advice about the route to reform. In gathering our evidence we made sure, through a series of nationwide roadshows, that we listened to as wide as possible a cross-section of small business taxpayer opinion, as well as to advisers and representative bodies.

What this exercise demonstrated was the diversity of thought about what simplification actually is. For some it is as simple as to stop making frequent changes to tax law. Others wanted better customer service and clarity of information from HM Revenue and Customs. However, what also emerged was an agenda which recognised that real simplification would only result if major issues, such as the integration of the tax and national insurance systems, were at last addressed.

More specifically we were also asked to look at IR35. 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.

In the report, we put before the Chancellor a menu of options to deal with this complex issue. We all hope that he will recognise the benefits to small business of the further work that needs to be done in this area and include the OTS in his preferred way forward on this issue.

In compiling this report we tried to make it as easy as possible for interested parties to contribute to our endeavours. To that end I would like to record my sincere appreciation for the tremendous contributions which were made to the report's production by the members of our Consultative Committee. Their debates and discussions were both lively and very well informed.

However, the results of our journey of exploration are our own and we accept the responsibility for the conclusions reached. In saying this I would like to pay tribute to John Whiting our Tax Director together with Kate Cottrell of Bauer and Cottrell, Partha Ray of BDO, Caroline Turnbull-Hall of PwC, and Tom Byng of Deloitte. Their efforts were brilliantly supported by a small but dedicated secretariat led by Jeremy Sherwood of HMRC, with Anish Mehta of HM Treasury playing a major role in coordinating this project. They have worked to very tight deadlines to ensure that this report can play its part in the Chancellor’s pre-Budget considerations.



Rt Hon Michael Jack

Chairman

Executive summary

The remit of the Office of Tax Simplification (“OTS”) is to provide an initial report to the Chancellor by Budget 2011 on areas of complexity and uncertainty for small businesses and recommend priority areas for simplification. This report is based on the work carried out by the OTS in the last five months, and focuses particularly on the 95% of UK businesses that have fewer than 10 employees. It incorporates feedback from the series of ‘roadshows’ we conducted around the country and comments from our Consultative Committee (whose details are in Annex F). We look forward to working with HM Treasury and HM Revenue and Customs (“HMRC”), as well as our Consultative Committee, on any recommendations that the Chancellor wishes us to take forward.

Major structural changes

The overwhelming conclusion is that genuine and long lasting simplification can only be brought about through major structural changes to the UK tax system. Our key recommendations are that the Government starts to look at reforming the structure and we recommend that a timetable be set out by the end of the year. The two key areas that require attention are:

- **The integration of income tax and national insurance contributions (“NICs”); and**
- **Introducing a radical new approach to taxation for the very smallest unincorporated businesses.**

Studies on how best to achieve this could be carried out, for example, by setting up a working party and through consultation with advisers and professional bodies within a specified timeframe. These changes, we believe, should address many of the issues affecting small businesses. The integration of income tax and national insurance, including reducing the differential between rates applicable to different incomes and legal forms, could, for example, remove much of the pressure on the employment and self-employment boundary and should result in the IR35 legislation becoming obsolete. Obviously, the position of pensioners, who currently do not pay NICs will need to be considered thoroughly.

If significant changes are made, we acknowledge that will require legislation and immediately add to the burdens on small businesses. One of the key findings is that complexity for small business stems as much from the volume and frequency of change as the complexity of legislation or procedures. Simply curtailing change would deliver simplification in many ways. However, introducing an alternative (but simplified) approach for small unincorporated businesses is worth exploring, to take away many of their administrative burdens. We have set out in greater detail the benefits of the proposal, as well as some of the issues that might need to be addressed, in Chapter 3 and Annex A of this report.

Provisional recommendations for other changes

The OTS recognises that the timescale to introduce the major structural changes above may be lengthy; accordingly, our report also suggests some changes that could be introduced within a relatively short timeframe to help ease some of the burdens on small businesses. The areas include:

- Improving elements of HMRC administration (and thereby its relationship with taxpayers);
- Choice of legal form;
- Simplifying reporting requirements on reimbursed expenses and benefits for employees;
- Improvements to the capital allowances regime; and
- Considering a simpler VAT system for small businesses that undertake international activities.

These recommendations are also set out in greater detail in Chapter 4.

Our remit requires the OTS to address the complexities that exist within the IR35 legislation. As indicated above, the structural change of integrating income tax and NICs would take away the need for IR35 but we recommend two options that the Government should consider adopting until the structural changes are introduced:

- Suspend IR35 with the intention of permanent abolition, using the period of suspension to investigate behaviours and costs; or
- Keep IR35 legislation unchanged, but improve the way it is administered by HMRC.

Our third alternative is to consider the introduction of a new **“business test”**. Although this option is not an immediate simplification (and would require more definitions and tests) it would aim to reduce radically the size of the population potentially caught by the IR35 legislation and thereby remove a large number of contractors from the worry of a potential IR35 enquiry. It could be investigated during a period of IR35 suspension. Detailed commentary is set out in Chapter 5 and Annex C.

We have presented these recommendations to the Chancellor of the Exchequer and expect a formal response as part of Budget 2011. We expect that the response from the Chancellor will set the work programme and timetable for the final report of the OTS review of small business taxation. We are not expecting the Chancellor to formally respond to specific policy options at this stage, and the OTS plans to evaluate these in more detail as part of our final report.

It is important to make clear that the OTS has been put in place to advise Government, and cannot make any decisions on policy itself. Ultimately, it is for the Chancellor to decide on changes to tax law, which would then be subject to the normal Parliamentary process. We also anticipate that, for changes of any significance, the Chancellor would initiate formal consultation on the proposals.

1

Introduction and background

Aim of the review of small business taxation (including IR35)

1.1 In July 2010, the Chancellor of the Exchequer announced the creation of the Office of Tax Simplification (“OTS”), and two initial reviews for the OTS¹. This is the interim report of the review of small business taxation, including IR35. The purpose of this report is to make recommendations to the Chancellor on how to simplify the tax system, ease administration and reduce uncertainty for small businesses.

1.2 There are long standing issues in small business taxation in the UK that have so far proven to be intractable. The UK is by no means alone in looking for improvements, and simplification programmes for small businesses have recently been looked at in Germany, the Netherlands and Australia amongst others.

1.3 Given this challenge and the resources available to the OTS, our particular focus has been on issues that we believe carry the greatest benefit. Accordingly, we have particularly thought in terms of micro businesses i.e. those with fewer than 10 employees and with either turnover or total assets below €2million per annum. Data from the Department of Business, Innovation and Skills (“BIS”) suggests that this covers 95% of UK businesses.

1.4 We have focused on three categories of issues². The first is structural changes to the tax system that can deliver major simplification. We also identify several areas of complexity with provisional policy options. Finally, the report sets out alternatives to IR35, as requested by the Chancellor at the announcement of the review.

1.5 This is in line with the terms of reference³ for the review in which the OTS was asked to:

- set out areas of the tax system that cause the most day-to-day complexity and uncertainty for small businesses;
- recommend priority areas for simplification; and
- consider the impact of ideas for simplification on different business sectors, including large business.

On IR35, the report should:

- 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; and
- consider the impact of the alternatives on tax avoidance.

¹ The review of tax reliefs published its final report on 3rd March 2011, following the interim report in December 2010. Further information can be found at: http://hm-treasury.gov.uk/ots_taxreliefsreview.htm

² Some selected issues in tax simplification that the OTS has not considered as they are already being looked at by Government are outlined in Annex D

³ http://www.hm-treasury.gov.uk/ots_smallbusinessreview_tor.htm

The principles to guide recommendations are:

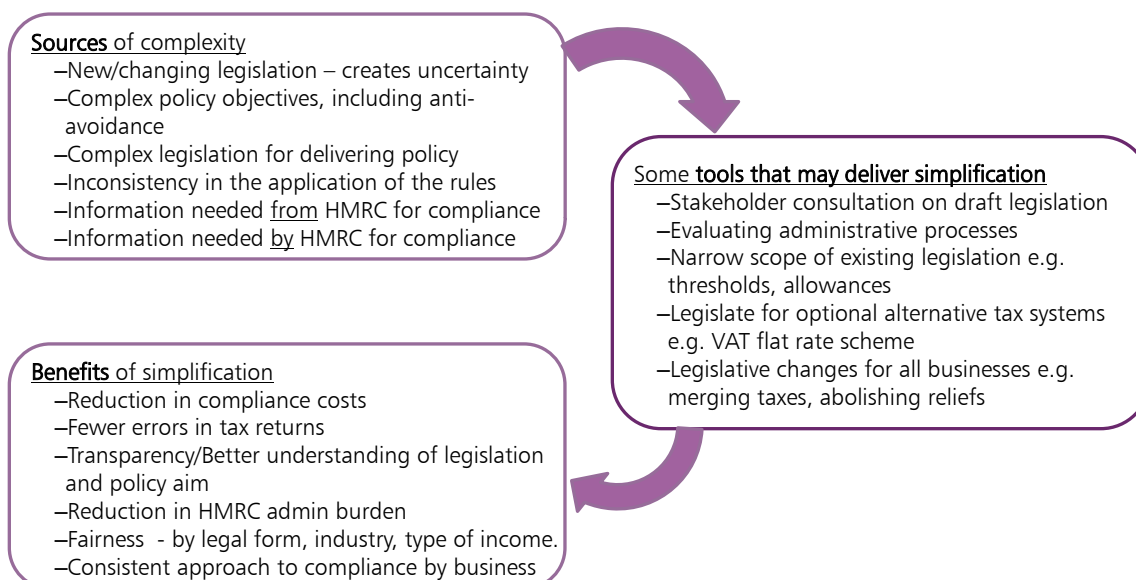
- build consensus amongst small businesses, tax professionals and academics;
- take into account current and emerging trends amongst small businesses;
- consider all HMRC taxes and duties that impact on small businesses, including the administrative burdens imposed;
- take into account Government objectives for labour market flexibility;
- be consistent with the principles for a good tax system, including fairness and efficiency;
- be broadly revenue neutral overall;
- be consistent with the Government's corporation tax reform agenda and wider tax reforms; and
- take account of international experience.

1.6 This interim report has been delivered in time to be considered as part of Budget 2011. Once the Chancellor has considered the interim report, we expect to receive guidance on areas to prioritise in the final report. By a deadline to be set by the Chancellor, the OTS intends to have investigated these priority areas further, with a view to recommending a package of specific policy recommendations for each.

What is meant by tax simplification?

1.7 The OTS review of tax reliefs interim report set out a summary of different definitions of tax simplification. The review of small business taxation has used the summary to develop a view on simplification to set the context for this report. This is set out below:

Figure 1.A: A summary of issues in small business tax simplification



1.8 Any policy recommendations should aim to deliver against these benefits of simplification. However, it is clear that any net gain in simplification may require trade-offs. For example, a policy that transfers obligations away from taxpayers may increase the burden on HMRC (and vice versa). The priority should be to deliver an overall improvement in administrative burden,

allowing individuals to focus on running a successful business and HMRC to target its resources more effectively.

1.9 Simplification must be achieved in a way that is consistent with wider objectives for tax policy.⁴ The ICAEW Tax Faculty set out ten key principles for a good tax system⁵, which the OTS has taken account of in this review:

- **Statutory:** tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
- **Certain:** in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the Courts in order to resolve how the rules operate in relation to his or her tax affairs.
- **Simple:** the tax rules should aim to be simple, understandable and clear in their objectives.
- **Easy to collect and to calculate:** a person's tax liability should be easy to calculate and straightforward and cheap to collect.
- **Properly targeted:** when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
- **Constant:** Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
- **Subject to proper consultation:** other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation.
- **Regularly reviewed:** the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
- **Fair and reasonable:** the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
- **Competitive:** tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

⁴ The House of Commons Treasury select committee has recently launched an investigation into the fundamentals of good tax policy.

⁵ http://www.icaew.com/index.cfm/route/133245/icaew_ga/PDF

2

Small business taxation: options for reform

2.1 The consultation process undertaken by the OTS raised a huge range of tax issues faced by small businesses¹. Using these views together with the analytical resources provided to us by our Consultative Committee and HMRC, the OTS has identified a number of priority areas in this interim report. These recommendations will be used by the Chancellor to set the work programme for the final report of the review of small business taxation.

2.2 It is important to make clear that a key message from the OTS consultation process was the benefit of making fewer changes to the tax system. The point is, simply, that change brings complexity because it means new rules and procedures to assimilate. A period of 'no change' would deliver a 'simplification dividend' by itself.

2.3 If change is to happen, the Government has a duty to make this as easy to deal with as possible by consulting widely on any proposed changes. This is very much in line with the commitments made by the Government through *Tax Policy Making: a new approach*² published in June 2010 with follow-up documents published in December.

2.4 We are very aware therefore, that in proposing changes, the OTS runs the risk of adding to complexity. However, we think that our proposals would pass a 'net benefit' test.

2.5 The OTS has a brief to be broadly 'revenue neutral' in our recommendations. We have had regard to this in framing our report, but have not undertaken detailed work to 'balance the books'. We think that is better undertaken when decisions are made on which areas warrant further study.

2.6 The recommendations in this report can broadly be broken down into three categories:

- **Areas for structural reform (see chapter 3):**
 - Integrating income tax and national insurance contributions ("NICs"), including the employment and self-employment boundary; and
 - Creating a radical new approach to taxation for the smallest unincorporated businesses.
- **Other priority areas that could be reformed on a shorter timescale (see chapter 4):**
 - Improving elements of HMRC administration including more efficient collection of Class 2 NIC and simplified monthly payroll;
 - Choice of legal form;
 - Reimbursable expenses and benefits for employees;
 - Improvements to the capital allowances regime; and

¹ This evidence gathering process is set out in more detail in Annex F.

² http://hm-treasury.gov.uk/tax_policy_making_new_approach.htm

- Consideration of a simple VAT system for small businesses which trade internationally.
- **Amendments or alternatives to the existing IR35 legislation (see chapter 5):**
 - Suspend IR35 with the intention of permanent abolition, using the period of suspension to investigate behaviours and costs;
 - Keep IR35 legislation unchanged, but improve the way it is administered by HMRC; or
 - Introduce a new business test to exclude a large proportion of the population currently affected by IR35 from the legislation.

3

Priority areas for structural reform

Integrating income tax and national insurance contributions

Box 3.A: Proposed integration steps

- Consistency in the definition of earnings;
- Consistency in the required calculations;
- Reliefs and exemptions on either income tax or NICs;
- Treatment of pensioners;
- Treatment of self-employment; and
- Treatment of savings and dividend income.

3.1 The issue of combining income tax and NICs has been raised frequently in workshops, formal submissions and email contributions. There was an almost unanimous view from small businesses and advisers that legislative change in this area can deliver genuine simplification. This is fundamentally linked to other sections of this report, namely the employment and self-employment boundary and the issue underlying the need for the IR35 legislation.

3.2 Maintaining two separate systems leads to a number of anomalies that provide incentives to distort behaviour. This leads to decisions being taken that are wholly tax driven, and in many cases are more complex and may not otherwise make commercial sense. Reducing the differential between the income tax and NIC rates and treatments for different income streams and legal forms would reduce this incentive and simplify the system for taxpayers, their advisers and HMRC. We do, however, recognise that reducing the differential will not be an easy task, to ensure that there is no significant overall loss to the Exchequer or taxpayers. It also needs to be considered in relation to the small profits rate of corporation tax.

3.3 As well as the reduction in fiscally motivated behaviour, the move towards a single tax and NIC system would result in significant administrative simplification. For example, there would be a reduction in the time and cost requirement of payroll calculations for employers, and completions of self-assessment forms for the self-employed. HMRC administration costs would also reduce, with less guidance required and greater scope for efficiencies in compliance, while there would also be a fall in the need for professional advice on tax efficient remuneration from the accounting and tax professions.

Structural reform

3.4 This is not a new issue. HM Treasury last publicly commented on this in the 2007 paper *Income Tax and National Insurance Alignment: an Evidence Based Assessment*¹. Since then, the Mirrlees Review produced by the IFS² has come out in favour of integrating the two systems into a single tax.

¹ HMT, 9 October 2007, http://www.hm-treasury.gov.uk/d/pbr_csr07_incometax713.pdf

² Mirrlees Review, "Tax by Design", Chapter 5, <http://www.ifs.org.uk/mirrleesreview/design/ch5.pdf>

3.5 There has been little progress on the issue given long standing reasons for maintaining separate levies on labour income. In particular, the contributory principle on which national insurance was established confers benefits based on contributions made. However, the original rationale behind NIC, i.e. to act as a social insurance system, is becoming less valid than even four years ago. The reasons for this include:

- The number of years of full contributions needed for a full state pension has been reduced;
- The reduction in number (and value) of benefits which rely on the contributory principle means there are now just six such benefits left - bereavement allowance, contribution based jobseekers allowance, contribution based employment and support allowance, incapacity benefit, maternity allowance and the state pension. Of these, the state pension is by far the largest in terms of cost. In addition, there is the prospect that the proposed new Universal Credit will erode this link;
- The Government proposal for a universal flat rate pension will further reduce the link to paying NICs.

3.6 Increases in the rate of Class 4, employer's Class 1, 1A and 1B, and additional rate NICs, which do not affect benefit entitlement, have increased the importance of NICs to the Exchequer. Given this contribution, there may be an aversion to the risks involved in implementing any new system. Due to the amount and regularity of PAYE and NIC receipts to the Exchequer, any changes must be fully considered and tested before any implementation. In 2010/11, income tax and NICs are forecast to raise c£250billion, or approximately 45% of tax revenue, of which NICs contribute c£100billion.

3.7 There are a number of issues that currently exist that lead to complexities in the system and distort behaviour. Many of these have previously been examined on a number of occasions in isolation but would be much reduced or eliminated through the integration of tax and NIC, including:

- **Employment status:** Even though employed and self-employed individuals pay income tax at the same rate, the total level of NIC for employees is 23.8%³ whereas for the self-employed it is only 8%. This creates an advantage for an individual to be self-employed and the implications of this are discussed further below.
- **Dividend v salary:** In addition to the income tax rates for dividends being around 15 percentage points lower than the rates for salary, dividends do not attract a NIC charge for either the individual or the company, compared to 23.8% on salary. A tax deduction (for the business) is available for salary payable, but not for dividends, which reduces the differential, but there is still a considerable incentive to operate through a limited company and receive dividends.
- **IR35 legislation:** In effect this has arisen due to a combination of the employment status and dividend v salary issues and would become redundant should income tax and NIC treatment, and the rates applicable to different income streams and legal forms, be aligned. This is explained in detail in Chapter 5.
- **Benefits:** The income tax and NIC treatment of benefits varies, with some exempt from both income tax and NIC (e.g. cycle to work), some exempt from income tax only (e.g. pension contributions), some from NIC only (e.g. payments in respect of

³ 11% for the employee and 12.8% for the employer; the differential between employed and self employed will soon widen with all rates rising by 1% from April 2011.

lost and stolen credit cards) and some from neither (e.g. health insurance). This creates confusion for both taxpayers and employers and is an issue that was highlighted in the final report of the OTS review of tax reliefs.

- **Income v capital:** In addition to the tax rate for capital gains being lower than that for income tax, capital gains attract no NIC whereas income attracts up to 23.8% for an employee. This provides an incentive for remuneration to be provided in the form of capital and has led to a number of schemes to be developed that attract capital treatment rather than income that are wholly tax motivated.

3.8 In addition to the above issues, differences in the limits and earnings periods of income tax and NIC cause confusion for many individuals and employers, with income tax being calculated on a cumulative annual basis and NICs on an earnings period basis (usually weekly). Those with two or more jobs (or a mix of employment and self-employment) are dealt with for income tax by PAYE and tax codes; but NICs require involved calculations, largely manual rather than automatic, to deal with NIC overpayments⁴. Temporary workers or employees joining near the end of the tax year may not be liable to income tax but in many cases would be liable for NICs.

3.9 As per Table 3.A there are nine different limits or thresholds, with (currently) seven different values. Combining some of these further to create just three limits would significantly simplify the understanding and operation of payroll.

Table 3.A: Income tax and NIC limits (2010/11)

	Income tax £	NIC £
		£
Lower Earnings limits	-	5,044
Primary threshold	-	5,715
Secondary threshold	-	5,715
Personal allowance	6,475	-
Upper accruals point		40,040
Upper Earnings limit	-	43,875
Higher rate limit	43,875	-
Withdrawal of personal allowance	100,000	
Additional rate limit	150,000	-

Source: <http://www.hmrc.gov.uk/helpsheets/e12.pdf>

3.10 An alignment of the earnings periods alone is estimated to result in net annual administrative savings of between £40.3million and £55.6million for employers⁵ comprised of the separate amounts set out in Table 3.B.

⁴ The OTS has been told that these 'maximum' NIC issues are regularly missed by taxpayers who do not have an adviser.

⁵ The 2007 paper by the Tax Law Review Committee of the Institute for Fiscal Studies sets this out in more detail: Integrating Income Tax and National Insurance: an interim report, IFS, December 2007.

Table 3.B: Net annual administrative savings through aligning earnings periods⁶

Reason for saving / cost	Estimated saving / (cost) £million
Quicker in year calculation and recording	32.7
Calculating and recording irregular payments	0.9
Calculating and recording director's NIC	8.7
Calculating and recording: Increased costs	(2.3)
Error correcting	9.7 – 19.4
Changes of employment	(19.1)
Employees queries	1.8
Simpler end of year returns	6.5
Easier payroll reconciliations	1.4 – 7

	40.3 – 55.6

Issues in integrating

3.11 Although aligning income tax and NICs should offer simplification for the majority of taxpayers, complexities could arise on implementation and it would cause issues for certain groups and income types. Issues to consider include:

- **Transitional arrangements and costs** – the 2007 HM Treasury paper estimated one-off costs of alignment of £200million. However, it also estimated the compliance burden for employers of operating income tax and NICs at £759million p.a., and an additional £300million for HMRC in collecting national insurance. Therefore, there are clearly significant administrative savings possible both for employers and HMRC, especially with the prospect of contribution records no longer being needed.
- **Exchequer impact** – the choices made on the definition of the tax base may significantly affect Government revenue. For example, increasing the 2011/12 primary threshold for employee NICs up to the income tax personal allowance would directly reduce tax receipts by over £1billion per annum⁷.
- **The resulting increase in the headline rate of income tax** – whilst in many cases this is a presentational issue, there may still be negative effects on the labour market as true marginal rates of taxation become clear. However, greater transparency over tax rates is needed for individuals to make informed decisions (e.g. on labour supply), a point made by the Mirrlees Review⁸. A factor here is the impact of tax credits, which blur the real rate of income tax further.
- **Pensions and pensioners** – there are some notable differences in the tax base for income tax and NICs, as pension payments are deductible for NICs but not income tax, and pension contributions are outside income tax but not NICs. In the longer term it could be an option to harmonise the treatment of pension payments and contributions (e.g. both deductible/both taxable). However there would need to be an interim solution as, clearly, suddenly increasing the tax rate on pension

⁶ Taken from "Income Tax and National Insurance Alignment: an Evidence Based Assessment", HM Treasury, 2007.

⁷ OTS calculations based on HMRC data published at: http://www.hmrc.gov.uk/stats/tax_expenditures/table1-6.pdf

⁸ Mirrlees Review, "Tax by Design", Chapter 4, <http://www.ifs.org.uk/mirrleesreview/design/ch4.pdf>

payments by 11% would be unacceptable.

- One possible route would be to have a different, lower rate of tax on pension payments. Although that adds a measure of complexity, the improvements to the PAYE system envisaged by Real Time Information suggest that is manageable. Another possible route could be to increase the personal allowance for pensioners in order to compensate them (though that would be only approximate).
- **NIC liability** - there is also the smaller issue of those of pensionable age who are still working being no longer liable to pay NICs (although their employers are liable for secondary NICs). The rationale for this revolves around the contributory principle, i.e. that NICs are a contribution to the state pension, so someone of pensionable age still working should no longer have to contribute. But how valid is that in an age where people are expecting to work longer?
- **Savings and dividend income** – these are both currently not subject to NICs, so bringing in a composite tax rate could lead to a substantial increase in the rate applied to this income. One issue to explore would be whether there could be differential rates of tax – a lower (composite) rate on savings and dividends income. Studies here should focus on the issue of whether such income should be taxed at a lower or higher rate than earnings – something that has fluctuated over the years and which is an issue that the Mirrlees review considered.
- **Employer NICs** – employers' NICs is a key element of the tax differential between employees and the self-employed and a key source of revenue for the Exchequer. This could potentially be funded by an increase in, for example, business rates or the tax rates applied to savings and dividends (in particular as dividends could be increased if employer NICs are no longer applicable).

Stages in integration

3.12 Although full integration of income tax and NICs offers clear benefits but presents clear problems, combination could be achieved in stages, each of which would pose fewer problems at each step but each of which would deliver incremental simplification benefits.

3.13 Steps which could be taken to align the tax bases⁹:

- **Consistency in the definition of earnings:** e.g. tax and NICs on benefits in kind and reimbursed expenses;
- **Consistency in the required calculations:** this includes aligning thresholds, calculating NICs based on annual and cumulative earnings, and assessing NICs liability on a per person basis rather than per employment;
- **Reliefs and exemptions on either income tax or NICs:** some of these discrepancies have been highlighted in the final report of the OTS review of tax reliefs¹⁰;
- **Treatment of pensioners:** one of the major issues identified is with the taxation of pensioners, as noted in paragraph 3.12. We also believe that any review would also need to cover issues such as the married couples allowances and the age related allowance;
- **Treatment of self-employment:** including examining current differences in NICs

⁹ Some of which are set out in more detail in the 2007 paper by the Institute for Fiscal Studies: *Integrating Income Tax and National Insurance: an interim report*, IFS, December 2007.

¹⁰ OTS "Review of tax reliefs: final report", 3 March 2011, http://www.hm-treasury.gov.uk/d/ots_review_tax_reliefs_final_report.pdf

between employees and self-employed and recommending potential, costed, methods to align the rates. As noted in Chapter 4, a potential initial step could be to combine Class 2 and Class 4 NICs; and

- **Treatment of savings and dividend income:** these are currently exempt from NIC and the OTS view is that the difference in the treatment to earnings is central to the tax motivation for incorporation and is a major incentive to operate a personal service company. This should be examined in more detail to see whether this income should be taxed at a lower or higher rate than earnings (this should be looked at in conjunction with the treatment of the self-employed, and employer NIC).

3.14 If the Government is minded to explore this proposal further then we would recommend that it sets out a clear timetable for these stages and work commences by the end of 2011.

Clarifying the employment and self-employment boundary

3.15 As noted in 3.8 above, the long term structural recommendation to integrate income tax and NICs treatment and rates applicable to employees and self-employed individuals, could take a good deal of the pressure out of the employment and self-employment boundary. However, it would not remove it as an issue, given wider issues such as employees' rights and employers' PAYE obligations. This section highlights the need for a solution.

3.16 The employment and self-employment boundary has always been difficult and confused. Arguably, it has not kept pace with changes in work patterns, with people having multiple employments, or with the nature of modern commercial relationships and their need for flexibility. Case law does to a degree give the answer, but that is time consuming and costly; it is also uncertain, and does itself evolve and change. Also the OTS has received representations that some find case law complex and difficult to apply.

3.17 The OTS believes this issue is closely associated with the recommended integration of income tax and NICs, and is one of the drivers of incorporation within the context of IR35.

The employed/self-employed divide

3.18 Employment rights have also changed since the introduction of IR35, where they too set out to differentiate between the employed and the self-employed. Terms such as consultant, freelancer, contractor, sub-contractor and agency temp are commonplace and suggest self-employment, but in reality they are often just labels, as each one could fall into employed status based upon the current boundaries, which are not always clear. Many argue that there are now three categories:

- Self-employed;
- Employed; and
- Freelancer.

3.19 Currently anyone considering working for themselves, or setting up their own business undertaking work for others, may have little certainty over their employment status. They may have made a positive decision to become self-employed but their status is affected by numerous different areas of legislation (as can be seen below) and can vary depending on what they do, who they work for and on the interpretation of hundreds of different tribunal and court cases heard over the last fifty years. Clarification of the status boundary, not just for tax but across Government, would be a major simplification. An individual should know at the outset that, irrespective of his or her choice of trade, he or she would be self-employed for the purposes of all taxes and fully aware of his or her rights (if any) to employment protections and benefits. The current lack of clarity poses a barrier to self-employment and is at odds with the Government's ambitions for creating growth.

3.20 There is a lack of consistency over the application of the employed/self-employed boundary. Within tax, it is possible to have a different status for income tax and VAT; beyond tax, employment rights are available to the employee but are increasingly being argued for a wider category of 'workers'. Tax can deem someone to be an employee but then the individual finds they are not entitled to employment rights or benefits. This is unfair and unsatisfactory; individuals should be able to expect consistent treatment.

Improving the position

3.21 The aim should be to deliver improvements across the whole status decision process. Individuals would have certainty over their rights and responsibilities. The decided status for the individual would then hold good in all fields. Employers using self-employed workers currently

run the risk of a status challenge by HMRC, with a potential liability arising for all tax and NIC (employers and employees) that should have been deducted, plus interest and penalties. Getting the status of one employee wrong over time can be enough to put a small employer out of business. A clear status boundary would give certainty to employers and help to create a level playing field for costs across all trades and industries. The policy is likely to lead to fewer contentious cases between HMRC and taxpayers, and benefit both HMRC and the Tribunal Service, thereby saving time and costs.

3.22 It is possible for an individual to have a different status for income tax to that for NIC. This complicates matters for employers and for the self-employed irrespective of the legal form through which they operate. For example, a visiting lecturer may be engaged by a university under a contract for services (self-employed) and accepted as such by HMRC for tax, but for NIC purposes the university has to account for Class 1 NICs. Although the lecturer is not an employee, the university is responsible for paying and recording employers' NICs and for deducting employees' NICs from payments to the lecturer. However it should be noted that where this occurs, it is by virtue of specific deeming Social Security regulations applying only to limited categories of workers, and is not a universal anomaly.

3.23 The status boundary affects behaviours. It is important to recognise the 'push' and 'pull' aspects here. Individuals can decide to pursue their careers as self-employed, as freelancers, consultants etc. Tax savings can be a factor in that decision, though for many it is a lifestyle choice. But the 'push' from employers is very significant. That has three key drivers, two of which push the employer (better now termed 'client') to require the individual to operate through a limited company vehicle:

- Protection from liability for employment rights and benefits (an increasingly significant factor, and one where employment law is causing change);
- Cost reduction through having no employers' NIC liability; and
- Protection against the risk of HMRC deeming the worker to be an employee and so assessing the employer for PAYE & NICs.

3.24 It has become a regular feature to find public sector workers operating through limited companies e.g. social workers, doctors, nurses, teachers and numerous roles within local authorities. These individuals may be operating through "umbrella" companies, that do normally pay salaries and hence PAYE/NICs.

Particular industries/occupations

3.25 HMRC created specialist units to deal with employment status in particular industries, for example the entertainment industry¹¹. There are numerous different occupations within the entertainment industry and within these occupations there are to be found different rules for tax and NIC employment status.

3.26 There is also legislation, special rules and guidance covering agency workers, sportspeople and construction workers.

Special cases

3.27 The NIC legislation, Social Security (Categorisation of Earners) Regulations 1978 applies to barristers' clerks, cleaners, directors, examiners, family employments, nominee directors,

¹¹ This covers film and video workers, television and radio workers, theatrical workers, musicians, orchestral players, behind camera workers and in front of camera workers, actors and actresses, voice over artists and Equity contracts etc.

teachers, lecturers and tutors and returning officers. HMRC sets out guidance in its manuals¹² on a further 31 occupations from agricultural harvest workers to those working in voluntary organisations.

3.28 OTS heard from members of the National Union of Journalists of the difficulties they experienced because of the variety of work undertaken as journalists. Many found that if they attended a school to give a talk about their profession they were treated as employed by the engager because of the teachers', lecturers' and tutors' rules.

3.29 A general view expressed to OTS was that the target of the teachers' rules had been extended by HMRC and now captured other occupations.

Construction industry and "false self-employment"

3.30 The construction industry falls into a special category and various schemes, measures and initiatives have been utilised since the 1970s to tackle what has recently been termed "false self-employment" in construction. The previous Government proposed the introduction of a legislative test to determine the employment status of workers in the construction industry for tax and NICs purposes.

3.31 A worker's income would have been deemed to be employment income (subject to PAYE and NICs) unless one or more of three criteria were met:

- the provision of plant and equipment;
- the provision of materials; or
- the provision of other workers.

3.32 The presence of one of the criteria would be sufficient to indicate self-employment. The responses to the consultation on the test were mixed, with some very supportive but many strongly against, not least because of the specific criteria suggested. The original proposals have not, so far, been taken forward, but Treasury officials have met with interested parties to explore whether it is possible to achieve a legislative solution. We understand that they are reporting back to Treasury ministers on the outcome of these discussions.

Employment law

3.33 Employment status is critical in establishing the legal rights and protections to which an individual is entitled to under employment law. Employment law is generally concerned with three types of status:

- employed;
- self-employed (and meeting the criteria for "worker"); and
- self-employed (and not meeting the criteria for "worker").

3.34 For the self-employed most rights fall away other than protections under health and safety and discrimination. Workers are entitled to rights such as holiday pay, National Minimum Wage ("NMW"), working time regulation protections etc. The starting point in all status cases under employment law is always to establish into which of the three status types the individual falls.

3.35 In the absence of special deeming rules (as in NICs), the same tests are used for tax/NICs status and employment law. However, as noted above, the complexity of the employment and self-employment boundary means that it can be possible for someone to be accepted as self-

¹² HMRC Employee Status Manual ESM4000 et seq

employed by HMRC for tax and NIC purposes but found by an employment tribunal to be an employee or a worker (and vice versa). Employment tribunals, like the tax tribunals, regularly deal with status cases and both have to consider case law precedent in reaching decisions.

Other areas affected by the boundaries

3.36 Aside from tax/NIC status, the employment status test is relied upon in many other areas of legislation e.g. UK Border Agency and immigration control, EU Agency Workers Regulations and the NMW. With no statutory definition of employment or self-employment, guidance provided by different Government bodies to define the self-employed does not tend to be consistent and this adds to the complexity for all.

State benefits

3.37 Once liability for a particular class of NIC has been established (e.g. Class 1 for the employed and Class 2 for the self-employed), rights to state benefits are assigned. Self-employed individuals pay Class 2 NIC, £2.40 per week (for 2010/11) and this gives entitlement to basic state pension, maternity allowance and bereavement allowance but with no rights to additional state pension, statutory sick pay or jobseekers' allowance. Self-employed individuals also have to pay Class 4 NIC on profits (for 2010/11, 8% between £5,715 and £43,875 plus 1% on amounts over £43,875) but the payment of Class 4 does not give any rights to further state benefits.

Possible policy options

3.38 The need is to deliver certainty to all those involved (including HMRC), whilst still allowing HMRC to tackle those who seek to go beyond what is permissible. That argues for a mechanism to deliver a firm decision on a worker's status which then holds for a period. The mechanism proposed for 'false self employment' in the construction industry is worth re-examining; the criteria proposed, and the justification in that consultation, were controversial but the underlying concept could be developed further.

3.39 There are steps that would reduce the difference between the two main statuses. Possible policy options include:

- Aligning tax and NIC in the longer term would remove the NIC "special cases";
- Changes in legislation to remove the NIC categorisation of earners' rules;
- Join up the consequences of employment across all Government departments/areas of law to maintain consistency; and
- Narrow the differences between tax rates on employment and self-employment.

An alternative approach to the taxation of the smallest unincorporated businesses

3.40 Many OECD countries have measures in place to reduce tax compliance obligations for small businesses¹³ such as an amount of tax based on standard levels of expenses, a flat rate of tax (e.g. on turnover) or a flat absolute amount of tax. These are discussed further in Annex A. It is recognised by the OECD that these can be an “effective means to reduce tax compliance costs and costs of tax administration”. The Government has already recognised the need for such measures for example through simplified schemes for VAT and the use of three line accounts. The OTS believes that there is also a place for a similar approach within the income tax system for very small unincorporated businesses¹⁴.

3.41 OTS analysis of HMRC administrative data indicates that in 2007/08 there were over 3.6million unincorporated businesses (sole traders and partnerships) of which over 2million (56%) had turnover of under £20,000¹⁵. Over 40% of these were not represented by a tax agent, compared with just 15% unrepresented larger businesses¹⁶. This presents greater scope for errors in the record keeping and returns of the smallest businesses.

3.42 Of the methods noted above, there are two that we believe are worth considering:

- A tax based on turnover, rather than profit; and
- Fixed (or flat rate) expense deductions.

3.43 Both routes immediately conjure up problems – the turnover-based tax inevitably ignores profitability and potentially taxes the trader with a modest profit harder than the service provider. Fixed expenses suggest a possibility of businesses not spending the money but claiming everything they can. But the OTS thinks the idea of a simplified system for micro businesses¹⁷ is worth exploring.

3.44 Businesses need to keep records of income and expenses. Partly this is so they know where they are financially (though it has to be noted that many micro businesses are guided primarily by the availability of cash). But for many a significant driver is to be able to complete their tax returns. The task of preparing accounts and calculating tax liabilities can be disproportionately burdensome for very small businesses (See Box 3.B), particularly where, as is common, there is mixed use of assets and services. The examples below illustrate the relatively large compliance costs of small businesses, driven by high fixed costs of advice, and the cost advantage available to businesses that do not use an agent.

¹³ OECD Tax Policy Studies Taxation of SMEs Key Issues and Policy Considerations No 18 page 125

¹⁴ Company law requirements mean that alternative approaches are unlikely to be appropriate for incorporated businesses.

¹⁵ Includes those businesses with zero turnover.

¹⁶ OTS analysis based on HMRC data

¹⁷ The eligibility threshold would be below the VAT registration limit and would probably preclude voluntary VAT registration; it would be for discussion whether a business with employees would be eligible.

Box 3.B: Illustrative examples of the disproportionate cost of compliance for small unincorporated businesses

'Typical' service industry business

The tax deductible expenses for a self-employed person with business turnover of £30k could typically be around £5k so the taxable profit would be £25k. Income tax (2011/12) on this would be $(£25,000 - £7,475) \times 20\%$, or £3,500. If the business uses an accountant charging a typical fee of say £550 (including VAT), the compliance burden of accountancy fees alone is around 16% of the tax bill.

Accountancy fees are likely to be similar for a lower turnover of £15k and profit of £10k. The tax would be £1,500 and tax fees would then be nearly 37% of tax due.

'Typical' business selling goods

Where a business is selling goods, expenses could be expected to be at least 50% of turnover, so on turnover of £30k the profit would be £15k and income tax £1,500. Tax fees may be a little higher for this type of business, probably around £650 (including VAT). The resulting compliance burden would be over 43% of the tax bill.

It must be stressed that the accountancy and tax fees will also probably include other services such as dealing with HMRC correspondence.

3.45 In addition to the fees charged by advisers, it is important to factor in the opportunity cost of tax compliance and the fear of investigation, which were reported to the OTS as being disproportionately high for very small businesses. In addition the administrative cost for HMRC of checking small business compliance, and helping them to get their fiscal obligations right, adds to the overall burden imposed.

3.46 Data from 2005 suggests that the overall administration burden for unincorporated micro businesses of preparing and completing tax returns and dealing with the associated obligations is over £565million p.a.¹⁸. Examples of the issues faced by businesses include:

- Lack of financial training and lack of understanding of accounting and tax concepts;
- Retaining and processing a lot of paper to claim relatively small amounts of expenditure, for example to calculate business use of home¹⁹; and
- Judgements about business use proportions and associated uncertainty over whether HMRC will accept them, for example, business use of telephone where the packages include free minutes and/or services.

3.47 A system that is simpler, cheaper and less time-consuming to operate could enable more taxpayers to submit returns without representation, reducing their compliance costs, and also providing more peace of mind over HMRC checks.

3.48 It may therefore be acceptable to allow claims for a reasonable fixed allowance for unreceipted expenses, albeit potentially lower than actual expenses, in exchange for certainty and simplicity.

¹⁸ Based on data from the 2005 KPMG admin burden survey. £565m is the total size of the top six obligations (in terms of admin burden) for unincorporated businesses.

¹⁹ Bills for power, water, mortgage interest, insurance, maintenance, Council Tax etc need to be split between fixed and running costs and then apportioned according to business use.

3.49 There would also be savings for HMRC in checking returns if claims are limited to fixed amounts. If the amounts are compulsory (as with 40p per mile for employee business mileage) the savings for both HMRC and businesses would be higher, but it is likely to create winners and losers, in terms of tax due. We therefore suggest that this system is optional.

Risks and other issues

3.50 It is possible that such an approach would appear to legitimise poor record keeping by businesses, and could lead to an increase in bad practices. However, some defined records would need to be kept and there would no doubt be some enrolment/registration formalities. Also, numerous businesses do have imperfect records which the tax system can accommodate, and in many instances the tax at stake is very low. By making the system optional, if the fixed allowance is lower than actual expenses incurred, an advantage would remain for those businesses who maintain records.

3.51 There is evidence that estimates and guesses are used in many small business accounts²⁰. Indeed general accounting practice for all businesses relies on estimates to some extent (e.g. in calculating bad debt provisions or warranty provisions). In addition, HMRC manuals instruct inspectors to accept reasonable estimates in certain circumstances²¹.

3.52 Allowing unsupported claims for certain business expenses may carry a direct fiscal cost. For example, if a fixed monetary amount is allowed, claims are likely to be at the allowed maximum level (even if actual costs are much lower), although this may be at least partly offset by some levelling down of claims to save on compliance costs.

3.53 There are already examples of this approach in the tax system²² and the design of the policy should set the amount at an appropriate level to minimise revenue loss but still cover a significant number of businesses.

3.54 There is the precedent of the VAT simplified schemes (flat rates). These have been successful, but there is evidence that they are viewed as something of a 'one way bet' – that businesses (or their advisers) analyse carefully their situations before deciding whether to go for the flat rate scheme. Only if going into the scheme produces a tax saving do they tend to opt in. It is not a simple decision to enter the scheme just because it offers easier administration. Advisers comment that if they did not do this sort of exercise for their clients, they would be vulnerable to negligence claims, and that the choice being offered actually adds to complexity.

3.55 One counter to the possibility of the possible flat rate scheme for direct tax being viewed in the same way as VAT is that it would be an option only available for micro businesses – say turnover of £20,000 or below. This therefore adds another factor to consider in determining the level at which to set the threshold, i.e. to ensure that businesses are not incentivised to understate turnover.

3.56 In addition, if the election is irrevocable, although the decision of whether to make it could be complex, once made, it would reduce the complexity of there being a choice.

3.57 It is also important to note that accounts and tax returns may also be used for other purposes (e.g. mortgages, tax credits) and therefore any changes to the way profits and tax are assessed would need to be understood by organisations using them.

3.58 We recognise that the introduction of an alternative approach does not necessarily result in

²⁰ For example, from an anonymised set of accounts obtained by the OTS, 85% of total expenditure of £9,978 claimed by one self-employed individual for the year ended 5 April 2010 was estimated.

²¹ For example HMRC Capital Allowances manual CA27005 and CA23087 regarding estimating non business use of an asset.

²² For example the option for employees to use £3 per week for use of home and for some self-employed individuals to use 40p per mile for business mileage, though the latter at least is not keeping pace with inflation.

simplification in all cases. There will always be issues for those operating at the margins of arrangements, and for those who move from one threshold to another²³. OTS analysis of HMRC data shows that approximately 13% of unincorporated businesses with turnover greater less than £20,000 in 2007/08 had turnover above £20,000 in 2008/09, and 6% of those businesses with turnover above £20,000 in 2007/08 had turnover below this level in 2008/09. A potential method to, at least partially, reduce the impact of introducing the option could be a 'year of grace' when turnover exceeds the threshold, to enable records to be brought up to the required standard. This would also negate the issue that may occur when turnover exceeds the threshold for just one year.

Further work

3.59 Suggested areas where further work could be undertaken to expand on this issue include:

- Reviewing simplified arrangements used in other countries and assessing how these contribute to simplification;
- Obtaining further data on the variability of turnover for the smallest businesses;
- Obtaining data from detailed small business accounts (which are often not submitted to HMRC) on the amounts and type of common expenses;
- Assessing potential loss of tax (and NICs) from the possible policy options;
- Obtaining data from HMRC on its costs associated with checking business expenses and the potential savings where claims are fixed; and
- Obtaining current data on compliance burdens relating to income and expenses and the tax receipts from these businesses.

²³ In the context of the VAT turnover threshold, the OTS heard about the negative effect on business growth and the increase in tax fraud amongst those that may breach the turnover threshold.

4 Provisional recommendations for other changes

HMRC administration of the tax system

4.1 This section has as its aim providing more certainty for businesses, and reducing their administrative burdens. The key is to give an early assurance that a business's tax affairs are in order, and to allow people to concentrate on their business whilst preserving HMRC's role in managing the tax system.

4.2 The difficulties associated with HMRC's administration of the tax system were raised frequently throughout the OTS consultation process. We were regularly told that HMRC was "feared" by small businesses, and that traders (or their advisers) spent too much time on 'defensive' work to ensure their tax calculations were robust. At the same time, there is a strongly held view that HMRC have small businesses in their sights as tax evaders; and that colours their approach generally. On HMRC's side, they have evidence to show that a substantial proportion of the tax gap is in the small business area.

4.3 There is also the question of problems caused by HMRC errors in their administration of the tax system. This is not to say that businesses and their advisers do not make mistakes. However, the OTS has heard many stories of problems caused for small businesses by HMRC's approach (this is not just an issue for small businesses of course). The point made, often very forcefully, to us is that businesses and their advisers spend too much time sorting out HMRC errors, or chasing matters to see if they are being dealt with, all compounded by time wasted trying to establish contact with the right person at HMRC. This is, naturally, a proportionately bigger burden for smaller business than for large ones.

4.4 It is clear that giving small businesses a better relationship with HMRC, and so simplifying their tax compliance processes may be even more beneficial than simplification of legislation. The difficulties with IR35 are a clear example of the level of disenchantment that can be caused by problems with administration. We recognise that transforming the relationship between small businesses and HMRC may not be achievable in the short-term. However, we suggest some areas below for HMRC to consider as a first step in improving their relationship with taxpayers.

4.5 A debate that took place in the House of Commons, on 2 March 2011, reflected some of the problems with HMRC's administration of the tax system. Andrew Tyrie MP (Chair of the Treasury select committee) suggested that HMRC needs to communicate better with taxpayers by finding ways of giving clearer and more accurate answers to reasonable queries. Mr Tyrie also recognised that HMRC staff need to have the training and experience to work with taxpayers. However, he recognised that the main reason for problems with HMRC administration is due to the complexity of the tax legislation.

The need for certainty

4.6 The OTS has spent some time probing small businesses and their advisers for what really does lie underneath these strongly-expressed concerns. The key issue can be summarised as: **certainty**. What is needed are changes to the way the tax system is administered so that it will deliver certainty to businesses; certainty that their tax affairs are clear and accepted and they can

move on and concentrate on doing business. This needs to be balanced with HMRC's legitimate need, which our commentators accept and support, to police the tax system.

4.7 A specific example of the increasing lack of certainty is the way that the rules on 'discovery' are extending. HMRC's assertions, increasingly supported by case law, are extending the boundaries of discovery considerably. The consequence is that the certainty offered in the principles of self assessment is being eroded.

4.8 We think there is considerable scope for efficiencies for all sides if the tax system works towards delivering increased certainty. The areas we recommend for further exploration are:

- Offering a rulings service in one or two defined areas that cause real problems for small businesses (the employed/self-employed boundary being a clear example);
- Improving information given out by HMRC staff (we are aware of concerns about inaccurate information flowing from some staff with insufficient training and/or experience); this must be accompanied by clear rules about when taxpayers can rely on HMRC guidance and what they have to do to earn the assurance;
- Defining areas that will be more likely to attract HMRC enforcement activities, so that traders are clearer about higher risk activities;
- More reliance by HMRC on the work of taxpayers' agents;
- A review system where HMRC becomes more accountable if it is adjudicated that HMRC has behaved unreasonably; and
- Examine whether a procedure for open and faster working between HMRC and advisers could lead to investigations being concluded within an agreed, set timescale.

4.9 Although our consultation has highlighted areas for significant improvement, we are aware that HMRC is working on its engagement with small businesses and with agents generally. In March 2010, a report published by HMRC states measures since 2006 will deliver administrative savings to businesses of £564million p.a.¹ It is important that further work continues on areas of HMRC initiatives including:

- enhanced online services which include a single registration form for the main business taxes;
- co-ordinating deadlines for filing returns between HMRC and Companies House;
- the introduction of an outbound email engine; and
- the development of the agent strategy.

4.10 HMRC gets a payback through more focused activity and better compliance by the majority of taxpayers who, fundamentally, want to comply. It also seems to the OTS that the direction of travel envisaged in this recommendation is broadly in line with HMRC's own thinking.

Assessing & collecting Class 2 National Insurance Contributions through the self assessment form

4.11 We discussed above the need for structural reform to NICs that might lead to a combination of Class 2 and Class 4 NICs. In the meantime, some administrative benefits would flow from modernising the way Class 2 contributions are assessed and collected.

¹ *Delivering a new relationship with business: Reducing burdens and helping businesses get it right*, HMRC, March 2010 (<http://www.hmrc.gov.uk/budget2010/new-rel-paper-1340.pdf>)

4.12 Most self-employed persons are liable to Class 2 NICs. The maximum liability is currently £124.80 per year rising to £130 from 6 April 2011. This is usually collected by monthly or quarterly direct debit, which is simple once set up. From 6 April 2011, payment of Class 2 NICs will be collected on 31 July and 31 January in the year of liability. From that date quarterly billing will be superseded by biannual or monthly direct debit payments, but this is not being collected through the self assessment system.

4.13 Problems can arise after the tax year end. HMRC has to calculate and refund any NICs paid by an individual which is in excess of the annual maximum NICs for the tax year. A self-employed person who has employment income will be liable to national insurance Classes 1, 2 and 4 and may pay more than the effective annual maximum. Such individuals can apply in advance to defer paying their Class 2 and Class 4 NICs until after total income for a tax year is known. The deferment process is paper based and has several stages.

4.14 Further, where business profits are below a 'small earnings' threshold, the individual may apply for a 'small earnings exception' ("SEE") from paying Class 2 NICs (Class 4 NICs would not be due) but cannot apply for deferment. This separate form and process, with different time limits, is confusing and frustrating for those whose earnings fluctuate above and below the threshold.

4.15 Given that all self-employed individuals must complete self assessment tax returns, the OTS recommends that the calculation of Class 2 and 4 NICs could become part of the self assessment process. Over 3.4million taxpayers are estimated to be liable to Class 2 NICs. Data shows that, in 2006, 9,195 individuals applied for deferment, 78,000 applied for the SEE² and 10,400 applications were submitted to have Class 4 NICs repaid.

4.16 A potential problem in changing the mechanism through which Class 2 NICs are collected is that any liability would become due 9 months after the end of the tax year (though some could come in earlier via payments on account). This could affect an individual who becomes entitled to benefits from the National Insurance Fund. For example, if the individual's entitlement to benefits arose on 1 January 2011, the Department for Work & Pensions ("DWP") would calculate the entitlement based on contributions to 5 April 2010. As the 2009/10 liability would not be payable until 31 January 2011 the individual may not receive his full entitlement.

4.17 We think the DWP, HMRC and HMT could find a workaround for such individuals.

Reducing the burden of the monthly payroll process

4.18 The feedback received during the consultation process was that small businesses are discouraged from taking on the first employee due to the associated payroll and employment regulation burdens involved. This is suggested to be a barrier to growth in private sector employment. Data from BIS shows that in 2009 75% of businesses in the UK have no employees, while less than 4% have one employee³.

4.19 The payroll burden includes the setting up of a payroll system, the monthly and annual forms that need to be submitted to HMRC as well as accounting for PAYE. Also, many small businesses are not comfortable with operating payroll and so incur the cost of a payroll agent.

4.20 In the past there have often been calls for HMRC to offer a payroll service for the smallest businesses. This has not been taken forward, though the ideas of 'centralised calculations' ("CC") in recent PAYE consultations goes a long way to meeting the calls.

4.21 One step that would help the smaller employer would be to remove the 'extras' that are

² Note that SEE is usually issued for 3 yrs at a time.

³ <http://stats.bis.gov.uk/ed/sme/>

grafted onto PAYE: maternity allowance, Statutory Sick Pay, attachment of earnings etc. This would leave the small employer with a 'plain vanilla' PAYE/NIC system, though naturally it raises other issues for Government.

4.22 In the absence of the HMRC or 'plain vanilla' options, rather than dealing with monthly calculations of tax and NICs, as well as PAYE returns, a small business, with three employees or fewer, could be given the option to pay a monthly amount of tax and NIC (agreed with HMRC) on behalf of an employee. This would be based on a percentage of the gross salary so that if, for example, overtime was paid, then the monthly tax and NICs would increase correspondingly. At the end of the tax year when the form P35 is completed, the balance of tax and NIC outstanding is calculated and paid and the employees' individual positions are calculated and adjusted.

4.23 This option does have problems for leavers, as there would not be an accurate amount of PAYE/NIC to enter onto their form P45. However, the same principle would hold: that the form P45 could show the amounts that had been deducted and paid over; the next employer, if an 'accurate' PAYE operator, would calculate the correct cumulative position in the normal way.

4.24 The option also has cash flow issues; the expectation is that HMRC would expect an 'over-deduction' route. Thus the employee would be out of pocket and not get into balance until 'month 13'.

4.25 The ongoing HMRC consultation about real time information does have an impact here. As noted, the CC idea, which was floated at an earlier stage of the process, but seems to have been put to one side for the present, would offer a route to reduce the burdens on small employers.

4.26 We recommend that these options are actively explored with the goal of removing from the smallest employers the problems of calculating PAYE & NICs.

Choice of legal form

4.27 Businesses normally operate through the medium of self-employment or through a company. During the cycle of a business, it may diversify and wish to operate each trade through separate entities or it may wish to operate through a different medium. The feedback from the consultation process was that businesses should be able to change the way they operate without being disadvantaged from a tax perspective.

4.28 For many businesses, incorporation may not be the most appropriate legal form. For some existing companies, incorporation may have been driven by reasons other than business need. The introduction of the 0% corporation tax rate in 2002 encouraged many unincorporated businesses to transfer their businesses into companies. The tax legislation continues to provide a mechanism for an unincorporated business to transfer its business to a company without suffering an immediate tax charge.

4.29 Running a business through a company requires compliance with Companies House legislation, as well as additional HMRC compliance requirements for directors. With the subsequent abolition of the 0% corporation tax rate, these businesses no longer see any benefit in being incorporated, and it has been suggested to the OTS that there is considerable non-compliance with corporate filing responsibilities. Owners of companies who would otherwise wish to revert to acting as self-employed individuals are discouraged from so doing as they might potentially be subject to an upfront capital gains tax charge and cumbersome procedures for winding the company up. However, it is acknowledged that the NIC differential does of course loom large as a driver to retain corporate status.

4.30 BIS are currently looking at whether action can be taken to reduce the administrative burden of those companies where the sole director and the sole shareholder are the same person (see Annex D). From a tax perspective, there is scope for a different approach to taxation of the smallest business; for example a 'lookthrough' basis which taxes the business ignoring the company. Another possible route would be that the smallest businesses are encouraged to operate as Limited Liability Partnerships ("LLPs") rather than limited companies (there would be a similar issue over a single person LLP as for a single person company) which would automatically achieve the 'lookthrough basis' whilst giving limited liability. These are clearly radical options that ignore the 'saving NIC' driver of many incorporations but they do offer some interesting possibilities.

4.31 If asked to take forward work in this area, the OTS would continue to take a close interest in the work of BIS and at the same time should explore the use by other countries of the 'lookthrough' concept.

4.32 Although this section focuses on the smallest businesses, the OTS's attention has been drawn to an area of complexity for businesses that wish to diversify and operate different trades through different entities. There are practical reasons for this:

- It is easier for the owners to determine the profitability (and viability) of each business;
- The managers of each business have more freedom to run their business as they see fit; and
- It will enable more profitable businesses to source capital more easily.

4.33 Finance Act 1972⁴ introduced the 'small companies' rate' (now called the small profits

⁴ FA 1972 S95(1)

rate) of corporation tax for companies whose profits did not exceed £15,000. Marginal relief from the main rate of corporation tax was available for companies whose profits were between £15,000 and £25,000. The rationale behind the relief was to enable companies with lower profits to have greater retained profits to enable them to finance their capital expenditure.

4.34 For 2010/11, a standalone company with profits below £300,000 is subject to corporation tax at the small profits rate of 21%. However, this limit is reduced by the number of associated companies (where one company is controlled by the other or both are controlled by the same person(s)). If a business decides to operate two trades through different companies where one trade makes profits of £200,000 and the other makes profits of £75,000, then the combined tax liability of both companies would be greater than if they had operated through one company.

Relief for disincorporation

4.35 One option is the introduction of a simplified process for incorporated businesses that wish to continue their trade through a different (unincorporated) medium. This would include a relief to enable businesses to operate in the legal form that best suits their commercial needs without suffering a tax charge. Currently, there is no such thing in law, as disincorporation; a company is either dissolved or liquidated and ceases to exist.

4.36 HMRC analysis in 2008 suggested that only a few hundred companies disincorporated in 2004/05. Given the immediate tax charge that may arise on disincorporation, it is likely that a relief to defer the tax charge may make it easier for more businesses to disincorporate, though the NIC differential may be a deciding factor towards keeping the status quo.

4.37 It is likely that any disincorporation relief would be restricted to small businesses; effectively those with a single main shareholder.

4.38 In concept, the disincorporation relief would offer:

- Any capital gains on assets that move from the company to the sole trader are held over;
- No stamp duty/stamp duty land tax on transfers of assets;
- Loss carry over, at least for trading losses, subject to the sort of restriction that applies on transfer of trades if liabilities are left behind;
- Continuation of capital allowance pools; and
- No CGT on disposal/liquidation of the company's shares.

4.39 Consideration needs to be given whether the cash within the company would be treated as a distribution when transferred to the unincorporated business or to the shareholder(s).

4.40 The result of taking this route would be that the company would be dissolved after a set period.

Harmonisation of corporation tax rates

4.41 Historically, the differential between the small companies' rate (now called the small profits rate) and the main rate of corporation tax has generally been 10% or greater. As the intention of the Government is to narrow this differential to 4% in 2014, we propose that consideration should be given to having a single corporation tax rate.

4.42 This would enable businesses to operate through as many different entities as they wished and, for these purposes, the associated companies rules could then be abolished. The marginal relief legislation and close investment company legislation would also become obsolete. The feedback we received suggests these would be welcome simplifications.

4.43 We are well aware that harmonising the rates implies that either the main rate has to fall or the small profits rate has to rise (or a mix of the two). These would be costly options. However, there are clear simplification benefits. One option to explore would be whether a rise in small profits rate could be balanced by an increase in the Annual Investment Allowance (possibly restricted to smaller businesses). That would also help unincorporated businesses, which have not benefited from the corporation tax reductions, yet have suffered reduced capital allowance rates.

Reimbursable expenses and benefits for employees

4.44 When an employee incurs expenditure on behalf of his employer and is reimbursed by the employer, the amount reimbursed is treated as taxable income. Where the employer does not have a dispensation (see below), the amount is entered on the employee's form P11D. As the employee is able to claim a deduction equal to the expense, the tax effect is nil but the administrative process of preparing forms P11D, especially for small businesses, can be labour intensive.

4.45 The rules require the employer to keep a record of all expenses reimbursed and enter this amount, and the associated VAT, on a form P11D. As an example, we were advised that a typical cost of preparing forms P11D for 25 employees was £1,200 p.a.

4.46 In addition, the employee, who might otherwise not have needed to complete a tax return, has to claim a deduction in his tax return to avoid being subject to income tax on the amount reimbursed. During our consultation process we heard of instances where small businesses are unaware that a deduction can be claimed by employees, resulting in the employees paying too much tax.

4.47 A business can apply for a dispensation but these are normally restricted to certain types of expenditure and might still require completion of forms P11D for other items. In any case, dispensations need to be reviewed periodically and feedback we have had is that applications for dispensations remain low.

Possible policy options

4.48 An immediate practical step would be wider promotion of the dispensation option, with clearer guidance from HMRC on:

- How to apply;
- What can be covered (and what cannot, with encouragement to concentrate expenses on those that can be covered); and
- What the benefits are.

4.49 There is a potential benefit to HMRC as well as to businesses in having more dispensations in place.

4.50 We recommend that consideration be given to the introduction of an exemption from reporting requirements where expenses reimbursed do not exceed say, £100 or £500. This may reduce the compliance costs for small businesses in particular, without requiring new legislation.

4.51 As an alternative, we propose that for the small business community, an exemption from reporting requirements is considered where the expenses reimbursed and benefits provided by an employer do not exceed £100/£500. We highlighted this in our review of tax reliefs report published on 3 March 2011 in which we recognised that the cost to the Exchequer may be significant and that further work would need to be carried out by HMRC and HM Treasury.

4.52 We also recommended in our reliefs report that the existing difference in the benefits code, depending on whether earnings were below or above the £8,500 threshold, should be abolished.

Capital allowances vs. depreciation

4.53 An issue that was regularly raised with us as a source of complexity is the calculation of capital allowances. The argument put forward is that allowing depreciation to be tax deductible for small businesses would be a simplification.

4.54 The problem is that the smaller business that this idea has in mind does not routinely prepare accounts of the sort that would show depreciation properly, thus there is rarely a balance sheet.

4.55 However, it was also noted in a number of our meetings that capital allowances do not pose a significant problem, and businesses would be unlikely to accept this change if it resulted in a greater tax liability.

4.56 In any event, the annual investment allowance (“AIA”) has meant that the smallest businesses can claim a 100% deduction for plant purchases. However, the reduction in the AIA to £25,000 from April 2012 brings this issue back into focus: we were cited many examples of small businesses whose occasional purchase of a single item of plant such as a tractor or a lorry would exceed the £25,000 limit.

4.57 The actual calculation of capital allowances was suggested by some as causing difficulties in practice. Given the AIA, and tax software, we do not see this as a significant issue, though we do acknowledge that the regular changes in capital allowance rates in recent years has caused some problems.

4.58 We would also note an unfairness stemming from the way the capital allowance rates have changed. The rates have changed for both incorporated and unincorporated businesses; companies have had compensation through some reductions in corporation tax rates but there has been no such compensation for the (much larger) population of unincorporated businesses. We appreciate that such matters are policy issues, rather than simplification matters within the OTS’s strict remit, but we have to record them given the way they have been brought to our attention.

Possible policy options

4.59 We do not think that a blanket move to tax-deductible depreciation should be taken forward.

4.60 However, there is scope to improve the position and help businesses with certainty. These include:

- As stated in the OTS’s review of tax reliefs report, fix on a level of AIA and keep to it for many years. The changes in limits are a real source of problems for smaller businesses;
- Consider allowing a small business to split a purchase that exceeds £25,000 over two years if that enables it to utilise otherwise lost AIA; and
- Develop a process to allow a small business that acquires an interest in a building to identify quickly and agree the plant component of the building.

VAT

4.61 The previous comments in this report apply mainly to income tax or corporation tax. VAT has also been raised regularly with us as something that needs simplification. We have probed these comments carefully and they seem to fall into three areas:

- Boundary issues – sorting out the zero-rating/standard-rating boundary for new items can be difficult for small businesses;
- Certainty – the fear that the ‘VATman’ is always liable to turn up to rake through past records; and
- International trade – it has traditionally been assumed that only large businesses carry out international trade and so find themselves liable to register for VAT in other countries; this is clearly not the case from our research.

4.62 There is also a perception that existing VAT penalties are unfair and burdensome, but in view of the current reforms of HMRC’s penalties we have not pursued this issue further. However, we recommend that this is kept under review through a formal evaluation of the new HMRC penalty regime in a year or two.

4.63 In addition we have discussed the VAT registration limit. A good number of those we speak to have called for an increase in the threshold, perhaps to £100,000, to exclude more businesses from VAT. At the same time, sometimes in the same meeting, some will call for the limit to be reduced radically, so that what they see as unfair competition is reduced as is the risk of small businesses not keeping proper records. It has to be said that there are more ‘raisers’ than ‘lowerers’. On balance we think the registration threshold should stay as it is, though it is an area that is worth further study⁵.

Possible policy options

4.64 We think that the key to solving the first two problems above is to set up some dedicated helplines and ruling lines to clear boundary problems. There should be a system of giving the trader certainty that their treatment will not be disturbed, or at least not retrospectively. It must remain open to HMRC to reconsider a position on the basis of new information, but the trader must not feel at risk of past treatments, honestly applied, being overturned. As with discovery, clear rules and rulings would give businesses certainty and reduce their concerns.

4.65 The prospect of giving rulings in this way may appear to impose greater burdens on HMRC but their payback is improved targeting of resources, and solving problems before they arise. It should also be possible to develop a rulings system that is available, at least initially, only to small businesses.

4.66 The international trade issue has a number of facets: deciding on VAT treatment (especially of services); dealing with VAT requirements in other EU states; and administrative returns. The way forward seems to us to be some form of simplified procedure for small businesses. We think this is something that the UK should suggest to the EU, on the basis that it would be an EU-wide initiative. But it would be open to the UK to develop an outline proposal and we would recommend that work is started, not least because it could produce a proposal to put to the EU as part of the response to the recent EC Green Paper on the future of VAT.⁶

⁵ As is well known, the UK’s registration threshold is the highest in the EU; a number of other member states have minimal registration thresholds.

⁶ “On the future of VAT: Towards a simpler, more robust and efficient VAT system” COM (2010) 695/4

Something to consider for the future: Aligning end of tax year with calendar month

4.67 There have been a number of representations to the OTS that the tax year for income tax and capital gains tax should move from 5 April and instead end with the calendar month (31 March) or calendar year (31 December). The example of Ireland's change in 2001 is given as a precedent.

4.68 The suggested benefits in terms of simplification from the change include:

- fewer errors on tax returns from transactions in early April;
- consistency with business planning and the tax year used for other taxes;
- consistency with the tax year used in the majority of other countries; and
- better understanding of the system.

4.69 These are ongoing benefits to business from the change. The change would also affect individuals who complete a self assessment for income tax, in that the deadlines would move.

4.70 However, there are considerable transitional costs to such a change. There is the upfront reprinting and reprogramming costs for literature and computer systems used by HMRC, banks and payroll systems. There is also the question of the timing of transition, which could be done through the use of a "short year".

4.71 The OTS view is that while there may be longer term gains from such a change, the immediate transitional costs mean that we have chosen to prioritise reform in other areas of the tax system. However, it is a reform that is worth a study.

5

IR35: issues and policy options

5.1 IR35 was announced by the previous Government in Budget 1999 as an anti-avoidance mechanism. Its purpose is to address the avoidance of tax and NICs on what may be employment income through the use of intermediaries, such as personal service companies or partnerships. The legislation was effective from April 2000¹ and in its early years was subject to a judicial review challenge which did not succeed. IR35 was not aimed at any particular occupation or industry. IR35 was amended in 2003 to include domestic workers e.g. nannies and butlers².

5.2 The OTS small business tax review was asked to look at the issue of IR35 in response to the view that IR35 as it stands is not particularly effective, yet is administratively burdensome. There have been vocal calls for reform over the years since IR35's introduction, but there is little consensus on the route to take. Where there does seem to be agreement is that the current legislation is little used, and largely "managed round" by contractors and others within its ambit, though often at some expense. At the same time it is seen as an important deterrent and part of risk management by HMRC. There has also been limited published analysis of the policy alternatives, although plenty of suggestions have been put forward.

5.3 IR35 affects all occupations and industries. However, all the high profile investigation cases concern those engaged in the IT and engineering sectors. No reliable data is available as to the current numbers affected by IR35, but a selection of relevant statistics include:

- HMRC data from forms P35 in 2007/08 and 2008/09, show that 70,000-75,000 declare themselves as service companies annually. Of these, 30,000 applied IR35 or the Managed Service Company³ legislation in 2007/08, while in 2008/09 this number had dropped to 9,500⁴;
- The Department for Business, Innovation and Skills ("BIS") analysis of data from Companies House suggests that there are 650,000 companies with a single director and shareholder who are the same person;
- The Professional Contractors' Group ("PCG") estimated in 2008 that there are 1.4million freelance workers in the UK. This figure includes self-employed sole traders and umbrella workers not directly affected by IR35; and
- A survey conducted on behalf of the OTS showed that the thirty accountancy providers that responded together represented over 30,000 limited company contractors.

5.4 The OTS has taken account of the diverse nature of the flexible workforce. The flexible

¹ FA 2000 s60 and Sch12

² FA 2003 s136

³ See Annex C, paragraph C5.

⁴ Concerns have been raised with this data as the questions are reported to have caused difficulties. Some ignored the questions on the basis that there is no legal definition of a "service company" or that answering the questions would trigger an IR35 investigation. HMRC's service company definition is also wide enough to capture small incorporated companies, for example, an accountancy practice with multiple clients, premises and staff not affected by IR35.

workforce cuts across all industry sectors and all occupations and the tax/NIC status of those engaged within it ranges from employees of third parties (agencies, umbrellas) through to those using personal service companies (“PSCs”). Types of worker range from the vulnerable low paid to the highly skilled, highly paid professional. Within the range of types of worker, some have no option but to work via an intermediary but others have made a positive choice to go freelance. Those operating through partnerships or PSCs are immediately affected by IR35 if, for example, they personally perform services for another person; however the impact on the wider population has to be considered.

5.5 In our view there are several areas of Government revenue that may be affected by changes to IR35 legislation. The managed services company (“MSC”) legislation does give some protection in this area:

- **Individuals currently operating through their own limited company that are within IR35** - In 2008/09, fewer than 10,000 individuals declared that they operated IR35⁵. Between 2002/03 and 2007/08, HMRC collected £9.2million in direct revenue from compliance activity;
- **The move to incorporation (PSC) of current full-time employees** – IR35 legislation presents a deterrent to incorporation for these individuals, but the OTS has not found any robust evidence on the effectiveness of this;
- **The move to incorporation (PSC) of individuals currently operating through umbrella companies** – umbrella companies are used by, amongst others, individuals that may be caught by IR35. Typically they are paid salaries (with PAYE/NIC applying) though not at levels equivalent to their full income. For many of these individuals, the potential tax advantage of a PSC is less than that for an employee⁶; and
- **The reduction in salaries currently being paid to limited company contractors** – survey evidence collected for the OTS suggests that less than 20% of limited company contractors pay themselves more than £12,000 p.a.⁷

Possible policy alternatives to IR35

5.6 We have held a number of discussions with key individuals and organisations associated with the IR35 industry, including those represented on our Consultative Committee (see Annex F). We have worked closely with these individuals, and with HM Treasury and HMRC to develop a number of policy options to improve the operation of the tax system in this area.

5.7 The OTS has also considered the experience of other countries including countries within Europe, the USA, Canada, Australia and New Zealand. Some countries have very stringent rules on corporate form. Others have identified tax avoidance issues on the boundaries between employment and self-employment and the tax treatment of employment income, and have their own versions of IR35.

5.8 The reality of the situation is that there is probably no clear cut legislative alternative that addresses the concerns of all parties. In some places, the existing legislation is an effective deterrent to the use of intermediaries for the purpose of reducing tax liability on employment income. However, it is clear that in many other instances IR35 as it stands is not effective, either for the individuals affected or for the Exchequer.

⁵ By “operated IR35” we mean those taxpayers who have assessed themselves as caught by the IR35 rules, we will use this shorthand in this section.

⁶ See paragraphs C.19-C.23 of this report.

⁷ This is approximately equivalent to a full time salary at the National Minimum Wage.

Box 5.A: Key points on IR35 made to the OTS during consultation

Following our discussions, the central messages on IR35 that the OTS has heard are:

- 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;
- individuals are unable to self certify IR35 status with certainty, and the fear generated by the enforcement of IR35 has created a significant industry in advice and insurance. At the same time there is wide knowledge and use of “IR35 proof” contracts and procedures, although these do not give the certainty that users crave;
- the risk of an IR35 investigation by HMRC, in simple statistical terms, is minimal;
- the longer term resolution of differences between income tax and NICs would remove the need for IR35; and
- 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.

5.9 We have been careful to ensure that our recommendations on IR35 are made in light of the most consistently reported messages from our wider consultation process, namely:

- that certainty is paramount and any policy change impacts negatively on certainty and can introduce complexity;
- HMRC administration of the tax system is a key element in the difficulties faced by small businesses; and
- the longer term objective of integrating income tax and NICs is by far the most wide-reaching simplification that could be made.

5.10 Within the context of a long term solution through the integration of income tax and NICs, the OTS has centred on some lead options to improve the current situation with IR35 legislation:

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

From the perspective of simplification, abolition of IR35 delivers the greatest improvement, providing individuals with certainty over tax status and removing legislation. Based on views heard by the OTS, this measure would be very welcome amongst the contractor community. However, there is a clear risk that, as a result, there will be greater use of intermediaries for the purpose of reducing tax liability on employment income. The OTS’s view is that a commitment from the Government to the integration of income tax and NICs, would lead to a reduction in the tax motivation for incorporation, and would limit the long term cost of this option. In the interim, the OTS proposes that the risk to the Exchequer could be mitigated through an initial suspension of IR35. The criteria and process for triggering the end of suspension would need to be formally announced.

The largest element of the fiscal risk is likely to come from the incorporation of current employees and the movement of workers out of umbrella companies. This may be exacerbated by the squeeze on salaries in the current economic climate and the aggressive marketing strategies used in the IR35 industry to encourage individuals to incorporate. The OTS is not in a position to calculate the amounts at risk but it could clearly be significant; work on the figures is needed and must be realistic.

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

Many people have told the OTS that after 10+ years of experience, the burden of IR35 has fallen, simply because it is well known. Individuals organise themselves to fall outside as a matter of routine. At the same time, it remains a burden, distorts decisions and is seen as ineffective. Whatever the potential numbers of those who could strictly be subject to IR35, the fact is that in practice few, if any, will be. Thus, although it has a deterrent power, its potential yield needs to be assessed with realism and care.

Improving HMRC's IR35 administration processes will deal with the issues raised to OTS including the fear of investigation, the length of time an investigation takes and will enable individuals to self certify their IR35 status with certainty saving time and costs. This option would also address the lack of consistency by HMRC in handling IR35 cases.

From the perspective of simplification this policy option would not result in legislative changes and should assist in creating certainty. If the Government commits to integration of income tax and NICs the OTS view is that this option is a viable short term measure to moderate the problem of IR35. HMRC will incur implementation costs but would make ongoing savings relating to better targeting of enforcement.

5.11 If the Government chooses not to implement either of these options, they may consider the introduction of a **genuine business test** to exempt certain businesses from IR35 entirely. This proposal would establish a range of simple tests that those within the ambit of IR35 could apply to their situation and be able to depend on the outcome through having a 'safe haven'. This aim would be that the great majority (90%+) of such businesses would know that they were outside IR35, and attention (of advisers, businesses and HMRC) could focus on the remainder. The test would be in addition to the current rules and the uncertainty these create.

5.12 The OTS received views from some of our Consultative Committee in support of this option and some very strong views against, on the basis that it adds another layer of complexity and is therefore not a simplification. The key problem would be how the tests were defined. To give one illustration, consider the one that suggests that a business with X or more customers would be outside IR35. How would customer be defined? A common sense definition could work, but what happens when a legal challenge is mounted? What sales would a customer have to receive to count?

5.13 It would, of course, be possible to use a very simple approach here; to set an overall level of salary that the PSC would have to pay to be outside IR35. We have considered (and discarded – see Annex C) the option of requiring a salary equivalent to the National Minimum Wage ("NMW"). A salary level would be one of the business tests. However, we note that one suggestion is that a pragmatic salary of £X up to turnover of £Y, salary of £P up to a turnover of £Q, salary of £Z otherwise, would be simple, if unscientific.

5.14 If this policy is considered, the evaluation of fiscal risk will depend on the difficulty of the test and could result in the removal of too many individuals from IR35 as the experience from Australia shows. The OTS recommends rigorous analysis and consultation on the criteria to be used in a possible test prior to implementation.

5.15 Further background to IR35 and analysis of policy options is set out in Annex C.

6

Conclusions and next steps

6.1 In line with the terms of reference for the review of small business taxation, this interim report sets out some areas of complexity in the tax system for small businesses, as well as some recommendations for changes to IR35.

6.2 It is clear that tax simplification is not straightforward, and that consensus on specific policy options can be difficult to achieve. In arriving at these priority areas, the OTS has balanced the expertise provided by a range of stakeholders, as well as the competing considerations for the design of tax policy. While this interim report may not satisfy those that have called for an immediate and radical overhaul of the system, it is our view that this staggered approach best serves the interests of the small business community and taxpayers at large.

6.3 The OTS recommends that work be taken forward on each of the areas highlighted, either in the final report of this review or elsewhere within Government. The priority areas recommended in this report are:

- The integration of income tax and NICs;
- Clarifying the employment and self-employment boundary;
- A radical new approach to the taxation of the very smallest unincorporated businesses;
- Improving elements of HMRC administration (and thereby its relationship with taxpayers);
- Choice of legal form;
- Simplifying reporting requirements on reimbursed expenses and benefits for employees;
- Improvements to the capital allowances regime; and
- Considering a simpler VAT system for small businesses that undertake international activities.

6.4 Once the parameters of the final report have been set by the Chancellor, the OTS will start to design a process for delivery, including obtaining advice and analysis in order to give final policy recommendations. We need to test whether our analysis so far is representative within the small business population, and also answer the specific questions that we have posed alongside the policy options in the annexes of this interim report.

6.5 On IR35, without structural changes to the system of tax and NICs, the OTS is clear that the issues underlying IR35 will continue to exist, and enforcement of legislation to combat this will continue to place burdens on both taxpayers and HMRC. However, on the basis that the Government progresses with an integration of income tax and NICs which could resolve the issue, we believe that there are two lead options to provide short term improvements. The ongoing involvement of the OTS on the issue of IR35 should be determined by the option that is chosen by the Chancellor. In line with the terms of reference for the review of small business taxation, this interim report sets out some areas of complexity in the tax system for small businesses, as well as some recommendations for changes to IR35.

A A radical approach to the taxation of the smallest unincorporated businesses

A.1 The OTS sees this route as an option for the smallest unincorporated businesses only – perhaps those with turnover below £20,000

Option 1: flat rates for certain or all expenses

A.2 In the same way as flat rate job expenses are allowed without proof of expenditure for certain employee occupations and there is a 5% expenses allowance within IR35, there could be similar arrangements for total business expenses or for certain categories of expenses e.g. use of home, stationery, postage, telephone. No private use apportionment adjustments would be required.

A.3 The flat rates could either be fixed monetary amounts or a percentage of turnover but only one option should be available for each expense category to avoid adding complication and choice.

A.4 Although this option is aimed at the very smallest unincorporated businesses, other unincorporated businesses could use this particular alternative basis if they do not wish to keep detailed expenses data, including data needed for calculating private use apportionments. However, it might well be restricted to non VAT registered businesses, not least to ensure registered traders keep VAT records.

A.5 The Government concluded in 2008¹ that there was too much variation in the ratio of expenses to turnover for a flat rate scheme based on turnover to be successful. However, the use of a fixed sum for certain expenses was not considered.

A.6 The fixed monetary amount option is the simplest to operate but could result in unfairness. Businesses which employ staff and/or produce products are unlikely to favour the same level of flat rate deduction as a service business. This can be taken into account in the arrangements. As an example, Austria allows expenses of 12% of turnover plus wages, cost of sales and associated taxes².

A.7 A fixed monetary amount which changes as turnover thresholds are reached may appear to be fairer but would result in high marginal rates of tax as turnover reduces and vice versa.

Option 2: tax based on turnover or other indicators

A.8 Some OECD countries such as Mexico and Poland apply a flat rate tax to turnover. The same tax rate may apply to all businesses with turnover under a particular level and/or different rates may apply to different sectors, as with the flat rate VAT scheme. The difficulty is that the approach does not have any regard to the different profit profiles of, say, the trader in goods as opposed to the supplier of personal services.

¹ http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/d/pbr08_simplificationreview_267.pdf

² OECD Tax Policy Studies No. 18: Taxation of SMEs: Key Issues and Policy Considerations, October 2009

A.9 This approach would remove the need for businesses to keep detailed business expenses records. Many businesses would of course want or need to keep records for other purposes, not least to establish their financial position. Careful consideration would need to be given to dealing with the transition from the alternative system to the general system when turnover increases.

A.10 Other countries in the OECD such as Spain use other indicators on which to base tax, for example number of employees, scope of activity, power consumption and, for restaurants, numbers of tables. In some cases the tax charge may depend on a combination of factors which would appear to reduce simplicity but may result in greater fairness.

A.11 Such indicator-based taxes can distort business decisions. For example, there could be a disincentive to move to larger premises or increase the number of tables in the restaurant.

A.12 Where the tax rate depends on business sector, one obvious issue will be allocating a business to a particular sector. This will not always be easy, as demonstrated by the number of business categories in the flat rate VAT³ scheme and the guidance needed for businesses which operate in more than one business sector.

Option 3: Standard lump sum payments

A.13 A radical alternative to the current system would be for small unincorporated businesses to pay a lump sum every year in lieu of income tax and Class 4 NICs. Certain company taxation regimes overseas⁴ use this basis for taxing companies resident in their regimes. In some ways this is like Class 2 NICs where anyone running a business has to pay it regardless of size and profits. The business would only be required to record turnover and not expenses.

A.14 The amount payable could also be banded according to turnover, although this could give very high marginal rates once a threshold is exceeded.

Option 4: Relaxing record keeping and accounting requirements

A.15 Many countries such as Australia, Germany, Norway and Belgium have simplified accounting, record-keeping and/or tax calculation regimes for small businesses. Many of these arrangements apply to businesses with turnovers well in excess of £100,000.

A.16 Further work is needed to understand the extent to which these policies reduce burdens on small businesses and potential for tax loss for the Exchequer.

³ See <http://www.hmrc.gov.uk/vat/start/schemes/flat-rate.htm#5a>

⁴ Isle of Man and some Caribbean islands

B

Further analysis of other provisional policy options

Assessing and collecting Class 2 (NICs) through the self assessment tax return

B.1 Benefits from the policy include:

- Reduction in collection costs, elimination of under-payments and over-payments with their associated processing costs; and
- Remove the need for the deferment and small earnings exception processes, and thus reduce annual costs for both HMRC and taxpayers.

B.2 Possible costs associated with the policy:

- If Classes 2 and 4 NICs are included within the annual self assessment calculation, changes will be required to guidance, to software and to self assessment forms to incorporate Class 1 NICs paid and the calculation of the annual effective maximum. We recognise that these changes may be costly but so are existing, largely manual procedures;
- It should be noted that if our recommendation was acted upon, in the year of the change the annual amount of Class 2 NICs for all self-employed will be paid up to 18 months later compared to the new arrangements from April 2011; and
- The link between payment of Class 2 NICs and entitlement to benefits needs to be addressed which could be by having a presumption that Class 2 NICs will be paid by those eligible, or that eligibility comes from Class 4 NICs.

Reducing the administrative burden of the monthly payroll process

B.3 Possible outline of the relief

- A small business to advise HMRC that they have taken on their first (up to the third) employee;
- The employer advises HMRC of the salary and HMRC advises the monthly tax and NIC due. Ideally, this would be the exact amount (via centralised calculation) but this option recognises a flat rate deduction as a possibility;
- At the end of the tax year, the employer (or a bookkeeper) calculates the total tax and NIC due for the year. A form P35 is submitted as well as the tax and NIC outstanding;
- When the business employs its fourth employee, PAYE/NIC is accounted for in the normal way; and
- The small business could alternatively have an option to run a 'plain vanilla' payroll, i.e. without having to deal with maternity allowance, Statutory Sick Pay etc.

B.4 Benefits from the policy

- Although a PAYE scheme will still need to be set up, a small business will no longer need to calculate (or hire someone to calculate) the monthly PAYE/NIC due precisely, which should reduce adviser costs; and
- If the de minimis limit for business expenses reimbursed is adopted then there may also not be any requirement to complete a form P11D.

B.5 Possible costs associated with the policy

- There may be a timing difference in revenue being received by the Exchequer; and
- HMRC admin costs e.g. collection of under-payments through notice of coding.

B.6 Issues

- Need to consider how to account for maternity allowance and Statutory Sick Pay;
- Also need to consider compulsory pension contributions;
- Need to define eligibility for the scheme;
- What if such a business ceases to trade before the end of the tax year and has insufficient funds to pay the outstanding tax/NIC?;
- What if an employee leaves before end of tax year? How do you manage multiple employments?; and
- Should the system be optional?

Relief for disincorporation

B.7 Benefits from the policy

- Facilitate movement between legal forms - there is already an incorporation relief for assets/businesses for tax purposes;
- Offer route to reduce administrative burdens associated with compliance with Companies Act 2006;
- Reduced adviser costs and time spent by business owner;
- Reduced cost for HMRC of administration associated with the business; and
- Potential admin savings for Companies House in not having to pursue corporate defaulters.

B.8 Possible costs associated with the policy

- Resultant anti-avoidance legislation may be complex;
- Increased tax and NIC liabilities for owners of unincorporated businesses;
- Increased burden for HMRC for administering new policy; and
- Increased record keeping requirements e.g. holdover relief and deductions claimed for intangible assets, for businesses which disincorporate.

B.9 Issues

- The relief should probably be restricted to small businesses. Given the practical difficulties of splitting asset ownership or having joint owners, this is primarily a route for effective sole traders. There is an argument that larger businesses with complex shareholdings would not wish to disincorporate. Those companies who wish to operate through a LLP can, currently, avoid an immediate tax charge by 'contributing' assets to the LLP. Extending the relief should not result in any loss to the Exchequer;
- Another option would be to have a window within which a company could disincorporate, so that the relief could be abolished in, say, 5 years;
- Protection for creditors (especially HMRC) can be built in but realistically HMRC has little protection with the company – potentially the disincorporation might help them as it is clear where the business goes;
- Final design of the relief needs to be considered against the methodology used in the OTS review of tax reliefs; and
- Should cash taken out of the company be treated as a distribution subject to CTA 2010 s103A (ESC C16)?

Harmonisation of corporation tax rates

B.10 Benefits from the policy:

- Enable businesses to operate through as many corporate entities as they wish without potential tax disadvantage;
- The associated companies legislation, for these purposes, could be repealed;
- Reduced cost for Government of administration associated with the business; and
- Calculations to maximise group loss relief surrenders would not be required so HMRC and businesses would save time and costs calculating, making and checking these calculations.

B.11 Possible costs associated with the policy:

- Reducing the main rate to the small profits rate would result in a substantial decrease in Exchequer revenue; and
- An increase in the small profits rate might result in the Government being perceived as unhelpful to small businesses.

Reimbursable expenses and benefits for employees

B.12 Benefits from the policy

- Businesses would not need to submit forms P11D if expenses reimbursed do not exceed £100/£500;
- Alternatively, small businesses would not need to submit forms P11D if expenses reimbursed and benefits provided do not exceed £100 or £500;
- Consequently, an employee would not need to submit expenses claims if the P11D

form only showed expenses reimbursed and benefits received below £100/£500. Further data is needed to see how many people this would take out of preparing a tax return; and

B.13 Possible costs associated with the policy

- Risk that some employers will provide tax free benefits up to the de minimis limit.

B.14 Issues

- Would a summary still need to be submitted to HMRC for amounts reimbursed to each employee?; and
- Similar policy in Germany - The German government recently approved a bill for the country's 2011 tax simplification law. One of its aims is to increase the tax deductible business expense allowance for employees to €1,000¹.

¹ The increase will exempt an additional half-a-million employees in Germany from the requirement for itemising their business expenses and it is estimated that 22 million employees (around 60% of all tax-paying employees) will not be required to provide any itemisation of their expenses.



IR35: background and analysis of policy options

The evolution of IR35 over time

C.1 Following the introduction of the IR35 legislation, “IR35 Solutions” emerged across the marketplace, which ranged from “bullet proof” IR35 contracts through to a range of IR35 “guarantees” and insurances. The first IR35 case (*Battersby v Campbell SpC 189*) reached the Commissioners in 2001. The case was won by HMRC. Following this case, there was a growth in IR35 status specialists.

C.2 The judgement in *F S Consulting v McCaul (2002 STC (SCD)138)* in 2002 confirmed the importance of the end user relationship with the individual as well as the contracts. Many advisors in the industry extended their IR35 review processes to include the working practices and HMRC also started to seek the evidence from end clients in investigation cases.

C.3 Since 2001, HMRC has won (i.e. IR35 applies) all three High Court cases (*Synaptec*¹, *Usetech*² and *Dragonfly*³) and won twelve cases at the Special Commissioners against six cases found for the taxpayer. Figures provided by HMRC for direct revenue from the enforcement of IR35 show £9.2m collected between 2002/03 and 2007/08, but it is not clear how many cases this covers.

C.4 However the great majority of IR35 enquiry cases do not reach the Courts or Tribunals and the total number of cases is not published by HMRC. According to data from the PCG as at March 2010, 1,485 cases were found in favour of the taxpayer against 8 losses. This suggests a considerable amount of wasted effort on all sides; although it is acknowledged by all that HMRC have a legitimate right to police the system.

C.5 The Managed Service Companies (“MSC”) legislation became law in April 2007⁴. This was the Government’s response to a large growth in mass marketed corporate structures where labour was being provided by individuals and the underlying contracts were ones of employment (i.e. IR35 was being ignored). HMRC estimated that the numbers using these schemes increased from 65,000 in 2002/03 to 240,000 in 2005/06. If the MSC legislation is found to apply, employment levels of tax and NIC are payable, with the possibilities of the liabilities being transferred to the MSC provider.

IR35 issues

C.6 The OTS heard views from accountancy service providers, agencies, umbrella companies, trade bodies, contractor membership organisations and some individual contractors.

C.7 One view was that, compared to the early days of IR35, contracting itself is in a relative slump based on 197,000 contracting jobs advertised in the first quarter of 2000 compared to the third quarter of 2010 with only 80,921 jobs. Many agencies thought that those that would

¹ *Synaptec v Young 75 TC 51*

² *Usetech Ltd v Young [2004] EWHC 2248(Ch)*

³ *Dragonfly Consulting Ltd v HMRC [2008] EWHC 2113(Ch)*

⁴ FA2007 s25 and Sch 3

expect to be caught by IR35 if they operated a personal service company instead operated through umbrella companies or worked via agencies on agency payrolls.

C.8 One view put to the OTS was that for those working via agencies, some of the uncertainty of IR35 stems from the need to create a notional or hypothetical contract. With no rights for the individual to see the contract entered into between the agency and the end client (“upper contract”), this was felt to be unfair given that it forms part of the IR35 decision. However, it was acknowledged that the upper contract can range from a detailed description of the role of an individual through to a simple purchase order e.g. to supply ten stress engineers.

C.9 Costs for IR35 advice were raised as an issue. Little use is made of HMRC’s IR35 unit who offer (without charge) opinions and advice⁵. Contractors do not use this service based on the perception that it can lead to a full blown IR35 investigation. As it is necessary to seek the views of the end client many contractors also do not want to “rock the boat” with the end client in this way. There is a clear perception that seeking out HMRC’s views on IR35 status would lead to stress and worry.

C.10 The general view put to the OTS was that most people are “managing” IR35 by relying on “IR35 proof” contractual arrangements. Many still face the psychological cost of threat of investigation. For those that obtain IR35 advice, the cost varies considerably. Many contractors get free advice from their accountants or use advisers offering to review all contracts over a 12 month period for £200. Some contractor websites offer free online reviews and some specialists charge £299 for each contract. At the extreme, one workshop attendee advised that a contractor had paid £2,500 for a review.

C.11 Cost of IR35 insurance was raised as an issue although this is entirely optional:

- Investigation insurance is not usually IR35-specific and covers for accountants’ and professionals’ fees for dealing with HMRC in respect of all enquiries. In some cases this is free or at minimal cost as part of other schemes or membership fees. If purchased independently a cost of £75 p.a. has been cited to the OTS.
- IR35 tax losses insurance also covers for any underpaid tax, NIC, interest and penalties. Scheme costs range from £199 to £399 per annum and usually cover all relevant contracts over the last 6 years. There are also guarantee schemes offered by advisers which are not regulated insurance and these are more expensive costing up to £1,000 p.a.

C.12 The OTS heard a wide range of views concerning the promotion of the use of intermediaries by agencies and engagers. Agencies dealing with those at the lower end of pay scales tend to operate the traditional agency model running their own PAYE scheme. Agencies dealing with higher paid professionals only tend to offer the limited company option i.e. either umbrella or personal service company. Protection for agents and engagers from employment rights claims⁶ and reduced administration costs were cited as reasons for requiring the use of an intermediary, while the absence of employer NICs provides a direct financial incentive.

C.13 OTS heard that incentives, in the form of the payment of commissions for the referral of individuals (and in some cases per timesheet processed) to some umbrella companies, are being paid to some agencies and/or to individual recruiters. Agencies and umbrella companies expressed concerns to OTS regarding compliance within the industry and lack of guidance and visible enforcement by HMRC of the rules.

⁵ There were 154 opinion requests between 1/8/2008 and 31/7/2009

⁶ If the employment status of a self-employed individual is challenged, the agency or engager may be liable.

C.14 A consistent view expressed to OTS is that the forthcoming EU Agency Workers Regulations (effective from 1 October 2011) will result in large scale movement of individuals from umbrellas to personal service companies.

HMRC enforcement

C.15 IR35 usually relies on HMRC to trigger an investigation, usually as part of a general employer compliance review. An IR35 investigation concerns the circumstances of the engagement which includes the contract(s) and the reality of the relationship between the individual and the end client. Once the facts have been established case law precedent is considered based upon HMRC's interpretation of the cases. As each case is decided on its own merits and particular facts there is a perceived lack of consistency in IR35 judgements.

C.16 The need to consider the written contracts, establish the facts from the individual and then from the end client add to the complexity and time needed to gather the information in an IR35 investigation. Investigations are made more difficult by the incentive on both the end client and the individual to maintain the status quo. The OTS found that there is little data currently available to confirm the cost to HMRC. Data shows that, for cases settled in 2009/10 or 2010/11, almost half took over 142 weeks to complete, and approximately one in five lasted for more than four years. This is clearly very stressful for the taxpayer, who wants to concentrate on his business. It is usually not possible for HMRC to give generic rulings on the IR35 status of a group of workers as the position of each may be different.

C.17 On its website, HMRC publishes some case law summaries and its interpretation of the findings of the case. However, this is confined to those cases HMRC consider important and updates are often not made for a long time and sometimes not at all for the cases that contractors consider to be important.

C.18 External experts have told the OTS that there has been a noticeable drop in the number of HMRC IR35 investigations over the last 18 months to 2 years resulting in low probability of being investigated for contractors. While many now effectively ignore the legislation, there remains a fear of investigation, particularly as they can result in liability for up to four years of backdated tax, and up to six years for NICs plus interest and penalties.

Umbrella companies

C.19 Umbrella companies play a significant role in the labour market for temporary workers, employing (with full employment rights) significant numbers of freelance individuals. The number of individuals operating through umbrellas was estimated to be 100,000 by HMRC in 2008, but the OTS believes that this significantly underestimates the current size of the market. An internet-based umbrella comparison site gives figures for approximately 90 umbrellas with 180,000 contractors in 2009. The OTS met with a small group of umbrella providers who have 18,000 PAYE contractors and paid around £180million in PAYE annually.

C.20 It is common practice for individual contractors to move in and out of different umbrella companies making it difficult to establish accurate numbers. A further complication over establishing numbers is the use of a "one-man" umbrella model or the use of several providers.

C.21 PAYE is collected by umbrella providers, but they can also be used as a vehicle for avoidance through travel expenses (as a result of incorrectly drafted overarching employment

contracts)⁷, and the use of salary sacrifice. It was estimated in 2008 that the cost of tax relief for travel for workers operating through umbrellas and/or agencies was at least £300m⁸.

C.22 Any salary paid to the individual, the PAYE deducted, benefits (such as holiday pay) and the umbrella providers fees all come from the gross sum paid by the engager. Individuals that operate through umbrella providers include those that do not wish to face the compliance burden of operating their own personal service company and those that feel at risk of being caught by IR35, although the two factors are not mutually exclusive.

C.23 A widely held perception expressed to the OTS is that many umbrella companies do not operate compliantly. There is scope for non-compliance with the administration of expenses, salary sacrifice and non-adherence to dispensations. A factor in this is the low perceived legal threat as little money is left within the umbrella company. There is further scope for non-compliance in the offshore market with the same issues, and with the added dimension of HMRC's difficulty in enforcement.

Incentives provided by the system

C.24 The personal tax system is set up to tax returns on capital investment less heavily than returns on labour. In effect, this can be an incentive for remuneration via dividends rather than salary i.e. a reward for incorporation.⁹ Table C.1 highlights the differences in tax rates for the employed, the self-employed and an incorporated individual. Individuals trade off this incentive with the greater employment rights that one should receive as an employee. In absolute terms, the rates are similar for the self-employed and incorporated individuals on £25,000 but the rates paid by incorporated individuals are over £5,000 lower than for the self-employed on £75,000.

Table C.1: Examples of tax and NICs liability in 2006/07¹⁰

	£25,000 earnings/profits per annum			£75,000 earnings/profits per annum		
	Employed	Self-employed	Incorporated	Employed	Self-employed	Incorporated
Salary	£22,737.06	£25,000.00	£5,035.00	£67,063.30	£75,000.00	£5,035.00
Income tax	£3,540.41	£3,993.00		£17,991.32	£21,166.00	
NICs						
Class 1 employee	£1,944.71			£4,030.05		
Class 1 employer	£2,262.94			£7,936.70		
Class 2		£109.50			£109.50	
Class 4		£1,597.20			£3,086.65	
Corporation tax			£4,392.30			£15,392.30
Dividend tax						£3,859.43
Total tax	£7,748.06		£4,392.30	£29,958.07	£24,362.15	£19,251.73
Net receipts	£17,251.94	£19,300.30	£20,607.70	£45,041.93	£50,637.85	£55,748.28
Increase in receipts compared to employed		£2,048.36	£3,355.76		£5,595.92	£10,706.35

Notes:

1. 2006–07 rates and allowances are used.

2. The tax calculations for the employed individual take into account both employer and employee NICs, i.e. they reflect the combined tax and social security cost of being an employee (rather than being self-employed or incorporated).

3. It is assumed that the individual choosing to incorporate pays himself a salary equal to the personal allowance with the remainder of the profits from the business extracted in the form of dividend payments, on which corporation tax and dividend tax (where appropriate) must be paid.

⁷ Includes cost of travel, subsistence and accommodation

⁸ Tax relief for travel expenses: temporary workers and overarching employment contracts, HM Treasury and HMRC, July 2008.

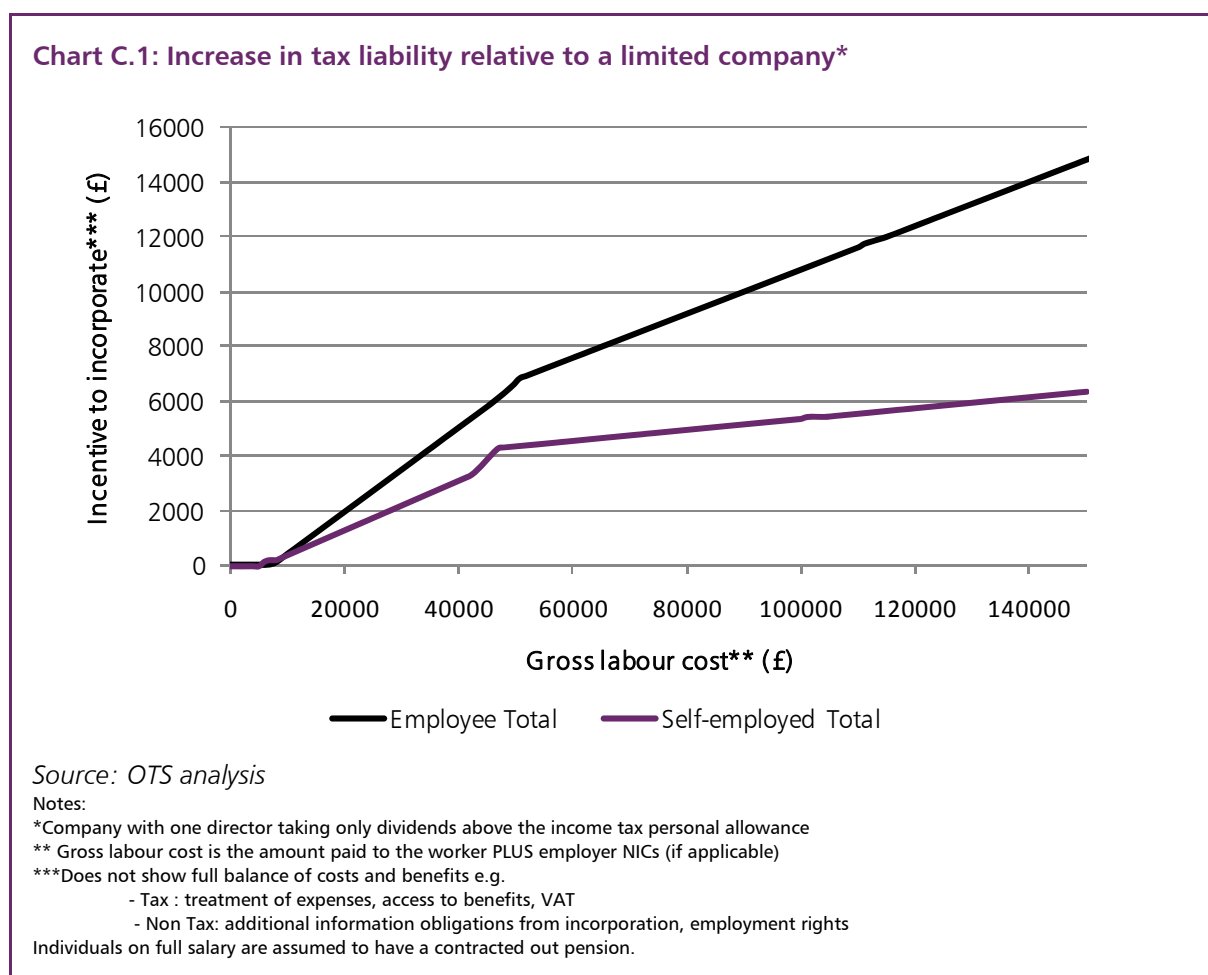
⁹ It should be noted that the tax raising powers in Scotland mean that rates on income tax can be varied which would change the size of the incentive. There is a large concentration of contractors in Scotland.

¹⁰ Taken from section 3 of "Small Companies Again" by Claire Crawford and Judith Freedman, 2007 British Tax Review, p439

C.25 Where IR35 applies, the individual broadly faces the employed levels of tax and NIC being paid. Those inside IR35 have the benefit of a 5% flat rate deduction on the gross fees they received before having to account for tax and NIC¹¹. Based on income of £25,000 (with no expenses and salary at the personal allowance) for 2011/2012 those inside IR35 would take home £18,150 and those outside IR35 £21,438. On £75,000 those inside IR35 take home £45,681 and those outside IR35 £55,815.

C.26 Generally, the higher paid contractor population commands much higher rates than their permanent equivalents and this is accepted as part of the trade-off with employment rights. If they were to pay themselves a weekly salary between £97 and £110 (the primary threshold) they will qualify for contributory benefits but do not make any NICs. For those that take a higher salary, tax liability can be reduced by claiming for the cost of travel to work, something that is not available to employees.

C.27 For 2011/2012 there are further incentives present with the proposed reduction in the small profits rate of corporation tax from 21% to 20%, the increase in the personal allowances and the potential to avoid the 1% increase in NIC by payment of dividends rather than salary. These far outweigh the increase in the higher rate tax levels. Chart C.1 shows the incentives in place in the tax system for 2011/12.



¹¹ Although the 5% can be viewed as an allowance for the cost of administering the company.

Policy options on IR35

Lead options

Table C.2: OTS analysis of a suspension of IR35

Policy	Suspend IR35 with the intention of permanent abolition
What is the aim?	To remove the barrier that IR35 poses to individuals that wish to operate in the temporary workforce.
How it works	<p>Suspension would take effect from a specified date, with the intention that in due course there would be permanent abolition. However, this announcement would come with the option to make the legislation effective again at some future point.</p> <p>During suspension, there would be no new IR35 investigations. The treatment of ongoing investigations would need to be confirmed. This option would require robust transitional arrangements to deal with those currently operating within IR35, and those currently being investigated for IR35.</p> <p>Suspension gives Government the option of monitoring the behavioural response to the removal of IR35 legislation. Criteria to use when monitoring behaviour during the suspension include:</p> <ul style="list-style-type: none"> • the rate of incorporation; • changes to salaries paid to directors of one/two person companies; and • movement out of umbrella companies or out of agency PAYE schemes into PSCs. <p>We recommend that the length of suspension be tied to the timetable for investigating the integration of income tax and NICs.</p> <p>Employer driven use of incorporated intermediaries (either PSCs or umbrellas) can occur even with IR35 in place. Provided it is enforced effectively, the MSC legislation provides a backstop to prevent “industrial incorporation” for large parts of an employed workforce, particularly at the lower earnings end. At the higher end, with no threat of IR35, the decision to incorporate would trade-off higher earnings with the loss of statutory and employer specific employment rights and benefits. Many of those operating via an umbrella company do so because of the risk of IR35.</p>
On what grounds is it simplification?	<p>The change would remove existing legislation and the resulting uncertainty over tax and NICs liability. It would also reduce the need for IR35 advice and insurance. Reduction in the enforcement costs for HMRC, although there will be some additional costs of transition.</p> <p>Tax motivated incorporation would increase. Signalling the integration of income tax and NICs would also reduce benefits from incorporating (although only in the longer term).</p>
Consistency with IR35 objectives?	<p>Abolishing or suspending IR35 effectively condones the significant underpayment of tax/NIC by some individuals. Although IR35 legislation is already ignored by some, this measure would appear to legitimise this behaviour. It is unlikely to be seen as fair by employees, particularly in the current fiscal climate.</p> <p>Abolition or suspension would encourage the genuine entrepreneur, and remove a cause of significant uncertainty for many limited company contractors.</p>
Consistency with wider Government objectives?	<p>Consistent with the growth agenda and encouraging entrepreneurship. Would reduce burdens faced by the individual, and the costs on all parties resulting from investigations. Clarity over tax status would remove a friction from the labour market for the temporary workforce.</p> <p>May impact on vulnerable workers or the lower paid being pushed out of umbrellas and into corporate structures with the lure of higher net incomes but at the cost of foregoing employment rights.</p>

Fiscal impact	<p>In one sense the cost would be minimal; the direct yield from enforcement of IR35 has been acknowledged as under £1million p.a. Losing that amount would be more than matched by administrative savings for both sides.</p> <p>However, the risk to the Exchequer would be significant and immediate. It depends on how contractors react to the suspension of IR35. There are several sources for this:</p> <ul style="list-style-type: none"> • It would not affect the Exchequer for those that currently ignore IR35 or manage their way around it. • But there would be a fiscal cost from those that currently pay under IR35. In 2008/09, this was at most 9,500 individuals. • Salaries in personal service companies would fall – However, survey evidence based on a sample size of over 30,000 showed that over 80% of limited company contractors pay themselves a salary of less than £12,000 per annum. • Incorporation of employees – The degree of behavioural response is highly uncertain, but is expected to be a major element of the risk to the Exchequer. As an illustrative example, calculations done by the OTS show that, under certain assumptions¹², the incorporation of employees could lead to a loss to the Exchequer of over £200million per annum¹³. • Movement from umbrella to limited company – Evidence collected by the OTS suggests that at least 180,000 individuals operate through an umbrella company. Survey evidence suggests that the tax loss for these individuals will not be as high as from the incorporation of current employees¹⁴.
Distributional effects	<p>All individuals currently and in the future operating via an intermediary will benefit from this change. Agencies and end clients may also benefit from this certainty.</p> <p>The Exchequer loss may mean that employees end up facing an additional tax burden particularly in the current fiscal and economic climate. Other losers include umbrella companies, specialist IR35 and traditional accountants, contractor membership organisations, contractor information web sites, specialist providers of IR35 advisory services, providers of IR35 tax losses insurances, and some agencies.</p>
Scope for avoidance?	<p>Scope for high earning employees to move to incorporation lured by this and the forthcoming rises in NIC. Employment rights and statutory benefits may not be of much value to highly skilled individuals, although the importance may have grown in the current economic environment.</p> <p>Pressure on umbrella or agency workers (on agency payroll) to move to a PSC to circumvent EU Agency Workers’ Regulations.</p> <p>Potential for abuse of other tax rules e.g. travel claims as many think that it is only IR35 that triggers investigations.</p>
Benchmark for success	No quantifiable changes in incorporation rates, no reduction in size of umbrella companies or agency payrolls.
Evaluation	Suspension – As well as the behavioural monitoring listed above, HMRC to analyse tax receipts at the end of each year of suspension.
Timing	Legislative change needed following consultation process. OTS view that it should be tied to the announcement of a timetable for assessing the integration of income tax and NICs.

¹² Given the difficulty in estimating the size of the Personal Service Company population, it is only possible to make illustrative calculations. Surveys conducted on behalf of the OTS sampled over 30,000 limited company contractors. We have assumed that a similar number of employees would incorporate following a suspension of IR35. Based on 2007-08 data from the Survey of Personal Incomes, this equals approximately 1.8% of individuals with employment income between £50,000 and £150,000. According to survey evidence collected for the OTS, a significant number of limited company contractors have turnover within this range.

¹³ The calculation assumes that the tax at risk for each of these individuals is equivalent to the tax incentive for an individual earning £50,000 per annum operating an aggressive dividend-salary strategy as per Chart C.1 of this report. This could be considered an underestimate as the size of the tax incentive increases with income e.g. the tax incentive at a salary of £150,000 is more than double that at £50,000.

¹⁴ Survey evidence from umbrella providers covering 30,000 individuals showed that approximately two thirds have income below £50,000 per annum. Those in umbrella companies can already claim for travel and subsistence costs. Survey evidence suggests that over 30% claim more than £300 per month.

Table C.3: OTS analysis of improving HMRC administration of IR35

Policy	Keep IR35 legislation unchanged but improve the way it is administered by HMRC
What is the aim?	IR35 to remain in effect but HMRC to commit to specific changes to provide better support to the IR35 affected population.
How it works	<p>Many people have said that after 10+ years of experience, the burden of IR35 has fallen. Individuals organise themselves to fall outside as a matter of routine. However, that itself is a burden. It has been clear that a genuine fear exists amongst those within the freelance workforce. HMRC processes are central to this issue.</p> <p>Examples of specific administrative improvements to ease this fear are listed below. The resulting changes must be significant and continually evaluated in order for this option to deliver any real improvements.</p> <p>Guidance</p> <ul style="list-style-type: none"> • publish any new IR35 guidance/information on relevant contractor web sites as well as on HMRC/Government sites; • use of the Employment Status Indicator in IR35¹⁵ and allow individuals to rely on the outcome; • Publish a list of “genuine business” criteria that individuals could use to self certify status with certainty; or • Alternatively, publish a list of what HMRC regards as bringing a real risk of challenge/ investigation (e.g. the “Friday/Monday” scenario, more than 2 years working for the same client, etc). <p>Selection of cases</p> <ul style="list-style-type: none"> • introduce more consistent selection of cases for investigation and ensure that they are only dealt with by specialists; • address the external belief that there is a link between tax/NIC yield identified/recovered and individual HMRC officers’ performance markings; and • eliminating the risk of investigation for those that have demonstrably taken reasonable care¹⁶, for example by conducting an IR35 review of contracts and working practices through a preferred supplier. HMRC to accept this opinion, with the proviso that there will be policing of the preferred suppliers list. <p>HMRC investigation process</p> <ul style="list-style-type: none"> • involve IR35 specialists at the outset (the fact finding stage) once IR35 has been identified as a potential issue by the compliance review/enquiry; • set a maximum investigation timescale (say 12 months) and use current powers to obtain information e.g. to overcome delays due to confirming the working arrangements with end clients; and • review the investigation process and standardise investigations e.g. some officers go direct to end clients before fact finding with the individual; <p>Reviews of investigations</p> <ul style="list-style-type: none"> • an independent review process for current and future IR35 enquiries carried out by IR35 specialists. • Introduce an independent mediation service similar to the role of ACAS in employment tribunals (Alternative Dispute Resolution is possible). If there is still no agreement/settlement the case could go to a fast track service for an early tribunal hearing.

¹⁵ The ESI was developed by HMRC using external consultation. For this change to be effective, further work may be needed on the ESI tool so that these external organisations reaffirm their agreement with the verdicts that it reaches.

¹⁶ As required by the penalty provisions

On what grounds is it simplification?	<p>The main issue for business is uncertainty; freelancers face an administrative burden as well as stress caused by the risk of HMRC investigation. The aim would be to give 90% or more certainty that they are in the clear.</p> <p>If an investigation is started, it can place an unjustifiable burden on individuals due to the time taken to resolve cases. HMRC approved guidance and transparency over the investigation process will help to provide clarity over the boundaries and address part of the fear amongst contractors.</p> <p>These changes would result in a modest upfront cost to HMRC. However, some changes could reduce demands on HMRC resources, for example by making use of independent specialists and setting time limits for investigations.</p> <p>This route also avoids introducing new rules; dealing with “the devil you know”, even if it is not respected, has its attractions.</p>
Consistency with IR35 objectives?	IR35 legislation would remain untouched. This option would allow existing legislation to better address the twin objectives of restricting the use of intermediaries to avoid tax liability of employment income, while not imposing barriers on genuine entrepreneurs. It would allow HMRC to target genuine abuses.
Consistency with wider Government objectives?	The aim is to target the real abuses and allow most businesses to be clear that they are not at risk. Those in the flexible labour market could find it easier to comply with the legislation, while the position could be made clearer for anyone entering the flexible labour market. Improvement to the investigation process would be helpful to all businesses in the contractual chain.
Fiscal impact	<p>Those that feel more at risk of investigation may start to operate IR35 or to move into a more highly taxed vehicle (e.g. umbrella). As it stands, there are many individuals that are ignoring the legislation given the perceived lack of risk.</p> <p>There may be some migration away from full employment or umbrella providers from individuals who are at low risk of investigation, although this group may be small. Some who are clearly at risk may nonetheless take the incorporation route (but they can anyway).</p> <p>The impact on HMRC spending will be determined by the specific changes that are made. The net impact will trade off the cost of implementation with the ongoing benefits from improved targeting of enforcement.</p>
Distributional effects	<p>Biggest losers from these changes would be those with greatest risk of being within the ambit of IR35, as enforcement is targeted more effectively. Providers of tax losses insurance and IR35 advice who have benefited from raised fears of investigation will face less demand.</p> <p>The IR35 population as a whole will gain from better guidance and advice. Those under investigation, both currently and in the future, will benefit from commitments over the length of investigation and an improved appeals process. Those in full employment are likely to find it fairer than the current situation where many simply ignore IR35.</p>
Scope for avoidance?	Possible risks if HMRC did not follow through and did not stick to the published process. More openness from HMRC may make it easier to circumvent the rules.
Benchmark for success	HMRC commitment to specific and significant changes. Reported improvement in the perception of IR35 by individuals
Evaluation	Regular forums with key representative bodies to discuss effectiveness of changes.
Timing	Commitment to specific changes to be established before the final report of the OTS review of small business tax

Table C.4: A possible ‘genuine business’ test¹⁷

Policy	Use a genuine business test to exempt certain individuals
What is the aim?	Providing certainty over IR35 status for some individuals currently affected by the legislation.
How it works	<p>The aim is to have series of tests that the great majority of those in range of IR35 can use to self assess themselves and so generate a ‘safe haven’ outside its remit.</p> <p>A list of objectively self assessed criteria to readily identify genuine businesses and eliminate them from the population affected by IR35. Those that do not pass the test would continue to face the possibility of an IR35 investigation as they do currently. The test should not aim to exclude all of those who are outside IR35 but to significantly reduce the burden in many cases where IR35 can be seen not to be appropriate, yet the current rules necessitate detailed consideration.</p> <p>There are alternative views on the “difficulty” of the test which would determine the proportion of population confirmed as being outside IR35. This determines the choice of criteria and the rule for “passing” the test. The criteria for this test could be agreed through public consultation. Experience from Australia demonstrates that fiscal risks and additional complexity can result from the introduction of tests in this area, but the “simplified alternative” approach is in line with that used elsewhere in the UK tax system. . The context, though, is that so few people are currently caught by IR35.</p> <p>It is important for the criteria to be objective and answerable in a binary way. There should also be different tiers of test, where at one level meeting just one test was enough to exempt businesses from the legislation and, at another, businesses would need to satisfy say 50% of a number of tests. The information could be provided as part of the tax return (additional questions on a corporate or individual tax return) and monitored on a risk-based approach. This would mean that activity in the previous year determines IR35 for the coming year. The information would cover the whole business and this is radically different to and far simpler than IR35 which looks at specific engagements.</p> <p>The tests would require further discussion but possible criteria to consider include:</p> <ol style="list-style-type: none"> 1. Diversity of paying customers during one year. Say 4 different customers with safeguards to show that each is a separate and distinct customer and the work from each forms an appropriate part of overall turnover (set a threshold). 2. Minimum capital investment - before setting up a limited company. The amount should be related to typical rates for the intended business activity. 3. Dividends – no more than six per year. 4. Minimum salary under PAYE as % of turnover – say one third 5. At least three employees 6. Providing equipment. Equipment essential to the work so that it cannot be completed without the equipment supplied by the individual. 7. Invoices for payment 8. VAT registration 9. Business Insurances 10. Evidence of business plans/cash flow forecasts/exit policies 11. Evidence of expenditure on marketing and promotion 12. Retained profits (set a threshold) 13. Tangible assets 14. Fixed fee agreed in advance for a particular task. Engager cannot move the individual around to other work. 15. Own premises and payment of business rates 16. Appropriate Industry accreditations/memberships

¹⁷This has been taken from a submission by the Professional Contractors’ Group to the OTS, and developed and analysed by the OTS.

<p>On what grounds is it simplification?</p>	<p>The new tests would work alongside the existing regime, such that for those clearly outside IR35 there is no change. For those currently within its ambit or concerned about the regime but not intended to be, it offers a simpler, quicker, binary, self assessed way of exempting themselves. Others on the margins of the legislation (or who falsely self assess) would still face the possibility of IR35 investigation.</p> <p>Clearer, pragmatic exclusion of genuine businesses from IR35 will lead to better understanding of the legislation and reduced costs of IR35 advice. For those that do not pass, compliance costs would remain unchanged, although they may face a higher chance of being investigated.</p> <p>HMRC admin burden could increase initially with changes to forms but the additional information could better inform compliance targeting and risk and research work. There will also be a cost to HMRC from monitoring the accuracy of evidence against the test criteria, although this would be traded off against fewer actual IR35 investigations.</p> <p>On the downside, introducing a business test will mean additional legislation, and a change to the system that all parties will need to adapt to. There are significant risks that any test may include criteria that are misinterpreted.</p>
<p>Consistency with IR35 objectives?</p>	<p>A well designed test would give freedom and certainty to those defined as genuine businesses, which are not the intended target of the IR35 legislation, tackling the key criticism of the current rules, that the capture net is wider than was the original policy intent. As such, the test would allow better targeting of IR35 enforcement. However, the test would need to be carefully implemented to minimise the risk that the test may eliminate too wide a group from IR35.</p>
<p>Consistency with wider Government objectives?</p>	<p>IR35 legislation that works better would remove the disincentive for individuals to start their own businesses. Certainty of status would remove uncertainty in business to business relationships in personal services. Both of these will allow small businesses to survive and grow more effectively and contribute to economic growth.</p> <p>Those that do not pass may move away from the temporary workforce, or into other employment solutions such as umbrella companies.</p> <p>IR 35 is still in place to police the blatant cases.</p>
<p>Fiscal impact</p>	<p>This would need further work as the tax impact will depend on the nature of the tests. Providing the tests are appropriately robust and the majority of those that pass are limited companies that already operate outside of IR35, the tax impact should be negligible:</p> <ul style="list-style-type: none"> • Very few of those currently operating IR35 should pass the test. <p>There may be some gain in tax revenue from those that do not pass the test starting to apply IR35 or increasing salary to meet the test.</p> <p>There could be some losses by an increase in freelancers setting up PSCs; but, being realistic, that route is currently available with little risk of being assessed.</p> <p>There will be indirect effects on the Exchequer from other behavioural changes to meet the test e.g. increasing number of employees.</p>

Distributional effects	<p>The biggest gainers will be legitimate contractors who currently face uncertainty over whether they will face an IR35 investigation, and those to whom this has happened. The resulting certainty over status may improve ability to find engagements. They would also be free to minimise tax liability, within the constraint of remaining a genuine business.</p> <p>A section of advisers on IR35 would lose out on this change. However since this business stems from uncertainty in the tax regime, in the context of providing a system which works better and is more in line with the original intent of Parliament, this is consistent with the Government's objective of wanting to simplify the tax regime.</p> <p>Those businesses not passing the test could face a higher chance of investigation leading to lower incomes or higher prices for services.</p> <p>Some employees (observing PSC users) would consider the tests fair but only if these clearly identify businesses and do not allow easy 'disguised employees'. May not be fair to traditional employers who bear the responsibility and liability for deciding the status of their workers. An extension to all workers may not be desirable and would involve rewriting employment law.</p>
Scope for avoidance?	<p>Potential for abuse if the tests are inappropriately designed, or enforced. However, Government consultation with stakeholders and other interested parties should help to minimise these risks. Submitting false information would trigger an investigation.</p> <p>Further scope if the questions on P35s etc have ambiguity or are poorly drafted. Criteria may end up being used beyond IR35 i.e. in employment status tests.</p>
Benchmark for success	<p>An appropriate cohort of limited company contractors are removed from IR35 with limited administrative burden.</p> <p>Design of test and enforcement provides a deterrent to submitting false information.</p> <p>Total number applying IR35 increases, as enforcement is better targeted.</p>
Evaluation	HMRC could analyse and test samples of forms P35
Timing	Further analysis of tests post-Budget

Discarded options

C.28 The OTS has considered a number of other suggested alternatives to IR35. Of these, two options are set out below, which, on the basis of the OTS's analysis, we do not recommend.

Table C.5: OTS analysis of requiring engagers to establish IR35 at the outset

Policy	Place onus on engager to establish IR35 status at the outset
What is the aim?	To provide individuals with certainty over the IR35 status of an engagement prior to taking it up.
How it works	<p>The engager (the end client where an agency is involved) would provide the terms of the notional contract (working arrangements) as defined by IR35 at the outset (i.e. prior to engagement) and following any changes to the role. This approach was ruled out at the time when IR35 was introduced due to the burden it placed on engagers.</p> <p>The EU Agency Workers Regulations (“AWR”)¹⁸, which are effective from 1 October 2011, will place a similar requirement on engagers. They will be required to review the terms and conditions of their employees in order to give broadly equivalent treatment to any individual (excluding the genuinely self employed) engaged by way of an agency. Working arrangements are already considered by the engager when a limited company contractor is engaged directly. However, this is part of the reason for using recruitment agencies¹⁹.</p> <p>Engagers are currently not concerned with IR35 and “disguised employment” as they are not at risk financially. However, they do benefit from these arrangements. Engagers would need an incentive to ensure that the reality of the working arrangements matches the written contractual terms especially where an agency is involved, possibly through a penalty for wilful negligence.</p> <p>The main problem with this approach is that the engager will only see one contract; yet the worker’s position as IR35 or not, although technically on a contract by contract basis, needs to be assessed on an overall basis that the end-user will not see.</p>
On what grounds is it simplification?	<p>Individuals will be able to use the defined status to make informed choices over engagements and will know the implications. HMRC could target enforcement on ensuring that engagers understand the rules and apply them to state the correct status, and may also save on investigation work as the notional contract would be visible at the outset. For a case involving an agency the contractor would have the end client’s view of the relationship up front.</p> <p>The policy would not address the key issue of clarification of the boundary for IR35, and would shift part of the burden of this on to the engager. There would also be a cost from transition to a new policy, and the resulting uncertainty would be contrary to simplification.</p>
Consistency with IR35 objectives?	This will benefit genuine entrepreneurs that seek engagements that are outside IR35. However, it may constrain those that are genuinely in business on their own account that wish to take up an engagement that has the characteristics of employment, for example as per <i>Hall v Lorimer ((1994) 66 TC 349)</i> .
Consistency with wider Government objectives?	<p>Consistent with the desire to give certainty to the status of all new jobs/roles, as per the AWR.</p> <p>Limited impact on end clients who engage contractors directly. However, those using agencies would now have to consider status for these workers in the same way that they are required for employees, with a resultant increase in costs and administration.</p>
Fiscal impact	Given that the majority of limited company contractors currently operate outside IR35 for all engagements, there is likely to be additional yield for the Exchequer as the number of engagements within IR35 increases.

¹⁸ Agency Workers Regulations 2010, SI 2010/93

¹⁹ Survey evidence based on a sample of accountancy providers representing approximately 30,000 limited company contractors showed that almost 70% were engaged through recruitment agencies.

Distributional effects	<p>Individual contractors will benefit from clarity over status. However, there may be an effect on net income due to pressure on contractor rates from the difference in demand for engagements by IR35 status. Contractors that are already on site and have considered themselves outside IR35 could lose out if someone new in the same role has been confirmed as inside IR35 by the new process.</p> <p>Engagers will lose out due to additional administrative requirements and possible sanctions.</p> <p>Those in the IR35 industry may lose out as certainty is provided to individuals, although engagers are likely to require IR35 advice.</p> <p>It should be seen as fair by employees as the engager has considered the same factors to decide status for all workers.</p>
Scope for avoidance?	<p>Engagements advertised as outside of IR35, regardless of working arrangements:</p> <ul style="list-style-type: none"> • Outside IR35 posts more attractive to contractors; • direct financial cost of getting it wrong do not rest with engager unless there is provision for penalties. • scope for collusion between end user, agency and individual.
Summary	<p>The policy option does not deal with the uncertainty over the boundaries of IR35 status. The policy would be onerous for engagers and also for HMRC in ensuring compliance. The cost transition to a new policy with new rules does not seem justified.</p>

Table C.6: OTS analysis of a minimum salary for company directors

Policy	Minimum salary at the rate of National Minimum Wage for company directors
What is the aim?	To reduce the tax advantages available to directors of limited companies by setting a minimum level of salary.
How it works	<p>This option proposes that a minimum salary level for company directors is set at the NMW level²⁰. This would ensure that some employment income of those in the IR35 population is subject to PAYE tax and NIC.</p> <p>Currently the NMW is not enforced for company directors unless the director also has an employment contract with their company. Where there is no employment contract, company directors can decide how much to pay themselves and whether to pay by salary and/or dividends. A common model for the IR35 population is to pay a low salary (below the personal tax allowance of £6,475 for 2010/11) and the balance in dividends, which are not subject to NICs²¹.</p> <p>The proposal would affect all company directors (not just PSC users). It does not appear possible to restrict the measure to those within the IR35 affected population, and targeting by other metrics (e.g. business size classification) raises concerns over fairness. Analysis of HMRC administrative data shows that approximately 750,000 individuals stated that they were a company director in the 2008-09 self assessment return²².</p>
On what grounds is it simplification?	<p>This measure would reduce possible tax/NICs saving and the incentive for tax motivated behaviour. However, commitments to increase the income tax personal allowance will reduce the differential with salaries at the NMW level. Savings on NICs and via income shifting will remain.</p> <p>The policy will not address the difficulties with administering and enforcing IR35.</p> <p>Business compliance cost will rise for <u>all</u> companies e.g. calculating hours and providing justification for this. This cost will be lower for those operating via an agency due to timesheets. HMRC admin cost will also increase as the new measure is enforced for all 1.4million companies in the UK.</p>
Consistency with IR35 objectives?	This may partly address the issue of fair taxation of employment income, but tax/NICs advantages of using an intermediary will remain. Wide coverage of the policy means that genuine entrepreneurs will be affected.
Consistency with wider Government objectives?	<p>This policy would affect current business decisions that may not be motivated by tax for many companies. For examples, some directors may not take salary in order to leave money in the company.</p> <p>NMW is associated with protecting vulnerable workers not with making the higher paid pay some tax/NIC so may not be well received by the rest of the population. There could also be a legal challenge to using the legislation in this way.</p>
Fiscal impact	Positive direct effect on tax revenue of increases in the proportion of total remuneration paid through salary ²³ . This could be partly offset by some levelling down of salaries that are currently above the NMW level.
Distributional effects	The main losers from this will be company directors that have salaries below the NMW level. All companies will suffer higher compliance costs. End clients and agencies may also face upward pressure on rates.
Scope for avoidance?	Likely to be a high cost of HMRC enforcement, resulting in the potential for avoidance/collusion over hours worked.
Summary	The group affected would go well beyond IR35 and personal service companies. The effect on the tax/NICs advantage from incorporation would be an insufficient deterrent to the use of a PSC.

²⁰ The National Minimum Wage (NMW) applies at a rate of £5.93 per hour for those aged 21 and above. For those working 40 hours per week for 48 weeks per year, this equates to a gross salary of approximately £11,500 per annum.

²¹ The size of this tax incentive is set out on page 63.

²² The sample covers individuals who stated they were a company director, and had both employment income and dividend income greater than zero.

²³ Data from 2008-09 self assessment returns shows that approximately two thirds of all company directors had total employment income below £12,000. £12,000 is used as an approximate for working full time for a year at the NMW rate.

D

Ongoing work on tax simplification within Government

PAYE reform

D.1 The consultation on Real Time Information (RTI), which closed on 28 February 2011, builds on last year's wider document on PAYE reform and builds on the NPS platform. At present, the Centralised Calculations idea seems to have been put to one side which is unfortunate from a simplification point of view.

D.2 There are concerns about the deliverability of the new systems and whether there will be new burdens placed on employers. Respondents to the consultations have highlighted such issues so the OTS has not investigated further. If RTI can be delivered, it does offer the prospect, from the perspective of the OTS, of reductions in the requirements placed on employers, which could lead to major savings in administrative costs.

Tax policy making: a new approach

D.3 The OTS consultation process has highlighted the negative effect on businesses of unexpected tax changes, and the difficulties that can be caused by rushed legislation. In December 2010, HM Treasury published its response to the consultation on the new approach to tax policy making. This response set out a number of specific improvements to the process for making tax policy.

D.4 The OTS view is that there can be a substantial gain in terms of simplification if the Government meets the commitments that have been set out.

General Anti Avoidance Rule (GAAR)

D.5 The Government has asked Graham Aaronson QC to lead a study to establish whether a General Anti Avoidance Rule (GAAR) would be effective in the UK tax system. This study will also consider the possible scope and design of a GAAR. The study will be completed by 31 October 2011 and Ministers will consider the outcome of this as part of the Budget decision-making process.

D.6 The volume and complexity of anti avoidance legislation is a significant issue. From a simplification perspective, the OTS welcomes an evaluation of options to reduce this burden. However, whether a GAAR (if one is proposed) is a simplification or another layer of complexity/uncertainty is a key issue. The OTS needs to monitor this study.

Single person corporate form

D.7 BIS has recently announced that it intends to review whether a corporate form for single person businesses could be introduced. This new form could introduce more flexibility and so simplicity, though that depends on administrative requirements. This new legal form could seek to reduce red tape for single person companies.

D.8 Although this is a measure looking at corporate governance, there are implications for tax policy. The OTS view is that this would increase the incentive to use personal service companies. From the OTS consultation process, it has become clear that the burden of operating a company reduces the use of personal companies¹. For some other businesses that are currently in the corporate form, disincorporation may be the most appropriate way to reduce administrative burdens.

¹ For example, some individuals choose to operate through an umbrella provider rather than a personal service company.

E

The small business population in the UK

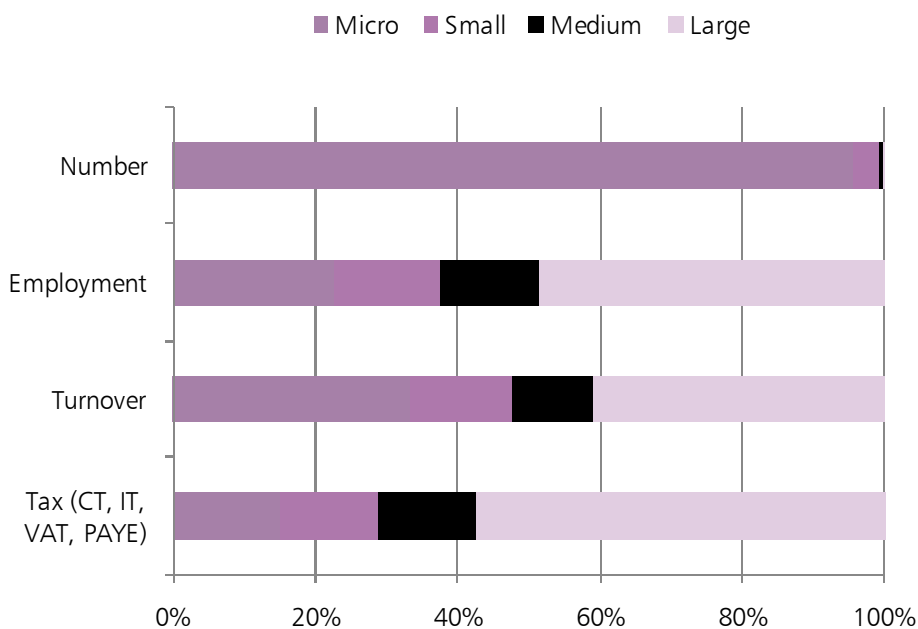
High level data on the small business population

E.1 The European Union categorisation of businesses by size is set out in Table E.1 below. This highlights the issue that the remit for this review of small business taxation covers businesses that are very different in terms of the scale of operation. When discussing sources of complexity and administrative burden, it has been important for the OTS to bear in mind that apparent contradictions may stem from this diversity.

Table E.1: European Union categorisation of businesses by size

Size	Turnover limit (€m)	Total assets limit (€m)	Number of employees
Micro	2	2	0-9
Small	10	10	10-49
Medium	50	43	50-249

Chart E.1: Share of number, employment, turnover and tax contribution by size of business

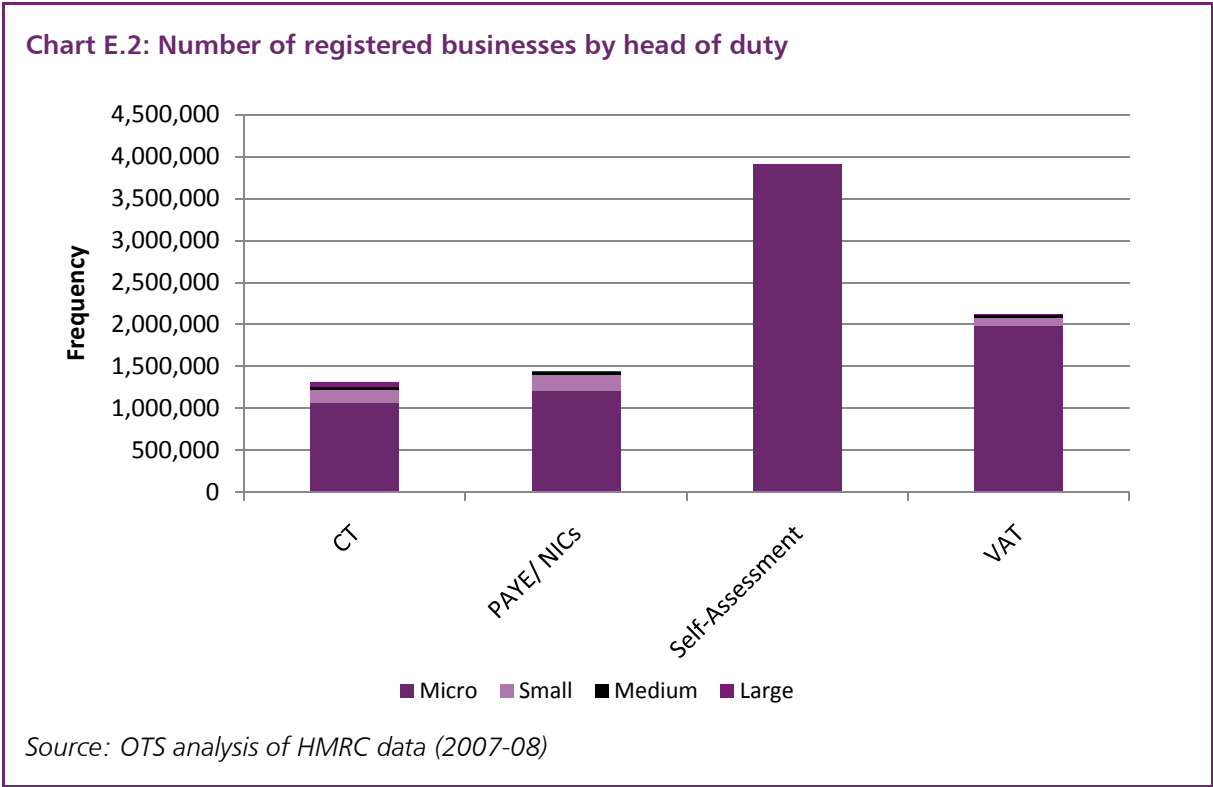


Source: BIS (2008), and OTS estimates using HMRC data (2007-08)

E.2 Data from the BIS shows that in 2008, 95% of the 4.9million UK businesses were classified as micro. Chart E.1 above demonstrates that micro businesses contribute more significantly to employment (23%) and total turnover (33%)¹ than they do to tax take (15%).

E.3 The idea of simplifying tax for small businesses has been welcomed by stakeholders during the OTS evidence gathering process. HMRC admin burden data from 2005 shows that micro businesses incur 61% of all compliance costs.² The apparently regressive nature of compliance costs may be due to the fixed costs of compliance and/or the higher (relative) opportunity cost of time spent on compliance. This fits with a recent survey of the regulatory burden on the UK’s smallest businesses³, which named the tax system as one of the three key themes to emerge, while other survey evidence suggests that two thirds of small businesses do not feel confident dealing with business tax without professional help⁴. The task for the OTS is to investigate ways in which the compliance cost faced by micro businesses in particular can be brought in line with their contribution to the Exchequer.

E.4 Data on the number of businesses registered for different heads of tax is set out in Chart E.2 below. This demonstrates the scope for delivering substantial improvements; changes that can provide small but robust improvements for micro businesses can lead to significant reductions in compliance cost at a macro level.



E.5 Chart E.2 above shows the number of businesses registered for each head of tax duty. Key points to note include:

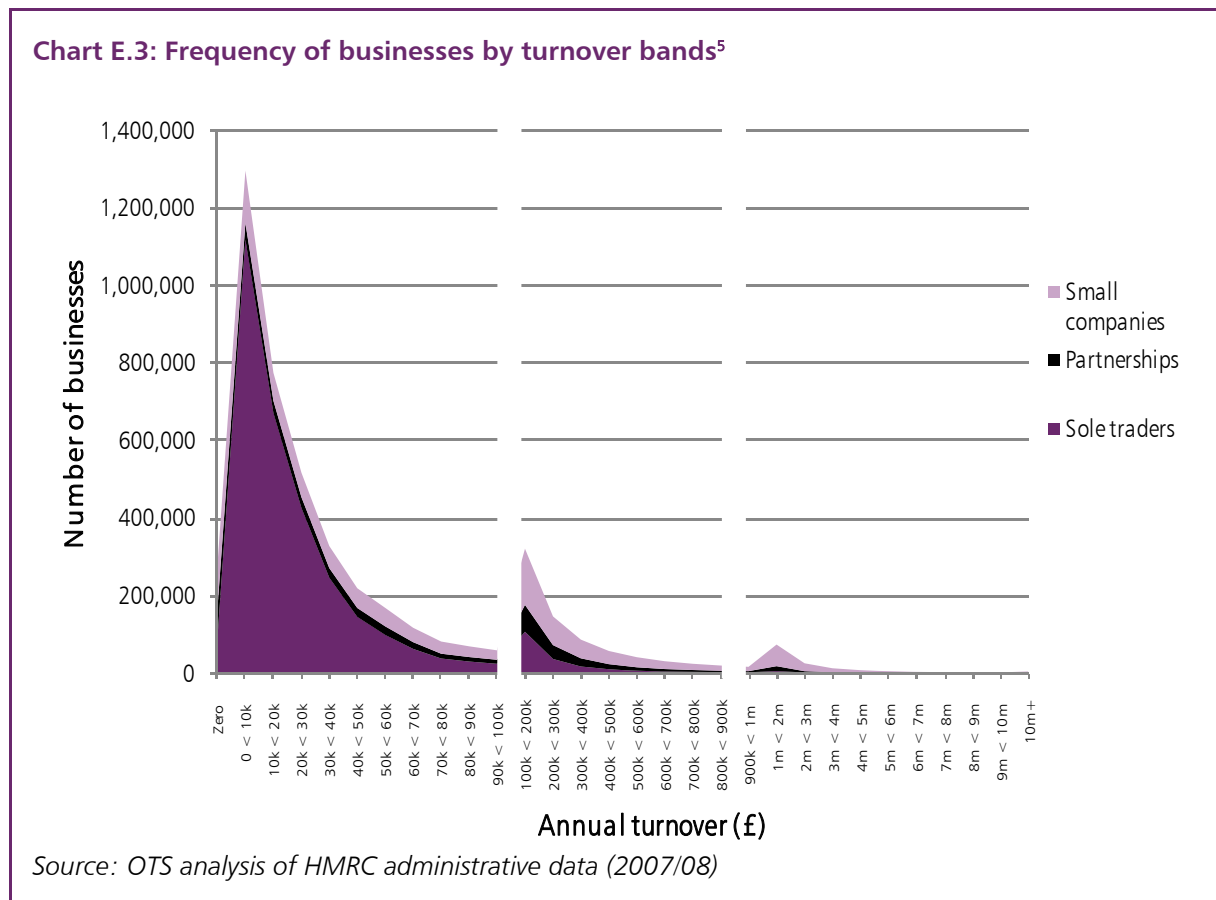
- The number of businesses registered for VAT is half the amount operating income tax self assessment. A key factor in this is the exclusion of businesses below the VAT

¹ By definition, medium and large businesses contribute disproportionately to these metrics.
² HMRC, 2005
³ BRE, Nov 2010 – *Lightening the Load*
⁴ The FSB-ICM ‘Voice of Small Business’ Panel, January 2010: http://www.fsb.org.uk/policy/assets/fsb-icm%20panel%20january%202010%20survey_report.pdf

turnover threshold (£64,000 per annum in 2007/08). This demonstrates the impact that exemptions based on turnover can have as a policy lever.

- Only a small proportion of micro businesses operate a payroll. This is consistent with data in paragraph 4.17 of this report, which shows that the majority of micro businesses have zero employees. An issue to probe is the split between those businesses that do not require employees for commercial reasons, and those that are deterred by the burden of taking on the first employee.

E.6 Chart E.3 shows the skew in the distribution of businesses towards lower levels of turnover. Excluding businesses with zero turnover, over half of all UK businesses (incorporated and unincorporated) have turnover below £30,000 p.a. Of the small and micro businesses in the UK in 2007/08, it is estimated that over 70% are unincorporated. Over 35% of UK businesses are unincorporated and have turnover above £0 and less than £20,000 p.a.



E.7 The small business population can also be considered diverse by other metrics, for example level of cross-border activity, use of technology, or level of research/innovation. As a way of capturing this diversity, the OTS has thought about the small business population using the following segmentation:

- entrepreneurial businesses – likely to grow and have funding requirements;
- traditional family businesses – providing living for proprietor and possibly extended family;

⁵ Note that the range of the bands are in three categories: £10,000 below £100,000 of turnover; £100,000 below £1million turnover; and £1million above this.

- businesses providing own labour/skills to others – no great overheads or investment; and
- lifestyle businesses – generally profit-making hobbies and sidelines.

E.8 This framework for analysis will be important when devising specific policy options, for example when developing an alternative system for the smallest unincorporated business.

F

The OTS evidence gathering process

F.1 During the last quarter of 2010, the OTS held approximately 50 meetings (including the workshops around the country listed in table F.1 below) with various stakeholders to discuss possible issues to consider as part of the review of small business taxation. As part of this consultation process, the OTS has travelled to Scotland, Wales and Northern Ireland, and also across England and has heard the views of businesses, contractors, advisers and Government.

F.2 Table F.1 below shows a list of workshops held by the OTS, and includes the various organisations that helped to make these events possible. The OTS held many other meetings with a wide variety of organisations and received written submissions, and is grateful to the various individuals and organisations that have taken the time to contribute.

F.3 The independence of the OTS, and the willingness of businesses to engage with our work, has been complemented by the knowledge held within Government. In particular, the OTS has drawn on specialists within HM Treasury, HMRC and BIS. While our focus has been on tax simplification, it is clear that in many cases this will have wider impacts that must also be factored in. Also, in a number of areas, the OTS has very helpfully drawn on the analytical resources within HMRC.

F.4 The Consultative Committee of the review of small business tax was put in place to act as a sounding board for the work of the OTS. The OTS has engaged the committee throughout this review, and the active involvement of the committee members has been invaluable. However, this report is the view of the OTS and not that of the committee. The full list of Consultative Committee members is set out in table F.2,¹ and the OTS would once again wish to thank them for their time and contributions.

¹ The original list of members of the Small Business Consultative Committee was published on the Office of Tax Simplification website in November 2010. Since then, some additional members have been added.

Table F.1: List of workshops held by the OTS Review of Small Business Tax

Location	Organiser	Date
Scotland (Edinburgh)	Chartered Institute of Taxation; Institute of Chartered Accountants of Scotland; and Institute of Chartered Accountants in England and Wales.	04/11/2010
South West (Southampton)	Institute of Chartered Accountants in England and Wales	08/11/2010
London	Institute of Chartered Accountants in England and Wales small business committee	11/11/2010
London	National Union of Journalists	12/11/2010
South West (Taunton)	Federation of Small Businesses	18/11/2010
London	Engineering and Machinery Alliance	18/11/2010
Scotland (Glasgow)	Chartered Institute of Taxation	23/11/2010
Scotland (Edinburgh)	Professional Contractors Group	23/11/2010
Scotland (Aberdeen)	Oil & Gas contractors	24/11/2010
Essex (Harlow)	Federation of Small Businesses	26/11/2010
London	Quoted Companies Alliance	29/11/2010
West Midlands (Birmingham)	Federation of Small Businesses	29/11/2010
Northern Ireland (Belfast)	Department of Enterprise, Trade and Investment	30/11/2010
London	London Chamber of Commerce	01/12/2010
London	UK200 Group	01/12/2010
North West (Warrington)	Freelancer and Contractor Services Association	02/12/2010
North West (Manchester)	Professional Contractors Group	02/12/2010
Yorkshire (Hull)	Hull & Humber Chamber of Commerce	08/12/2010
Yorkshire (Hull)	Chartered Institute of Taxation and ICAEW	08/12/2010
London	Professional Contractors Group	08/12/2010
North East (Newcastle)	Federation of Small Businesses	09/12/2010
London	Providers of umbrella and accountancy services	09/12/2010
London	Agencies	09/12/2010
South Wales (Cardiff)	Association of Chartered Certified Accountants	10/12/2010
East (Cambridge)	Deloitte clients	15/12/2010

Table F.2: Members of the Consultative Committee of the review of small business taxation

Andrew Hubbard

Andy Richens

Angela Williams

Anita Monteith

Anne Redston

Brian Sloan

Chris Bryce

Chris Try

Crawford Temple

Erin Robinson

Gillian Econopouly

Guy Bridger

Judith Freedman

Lionel Griffiths

Martin Hesketh

Peter Gravestock

Phil Needham

Richard Baron

Robin Wythes

Simon Hacker

Simon Pemble

Simon Sweetman

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This document can be found in full on our website at:

hm-treasury.gov.uk/ots

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