

# Intermediaries Legislation (IR35): discussion document

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# Introduction

At the Budget the government announced that HMRC would start a dialogue with business on how to improve the effectiveness of the existing intermediaries legislation, commonly known as IR35. HMRC will engage with stakeholders over the next few months to explore options to make the legislation more effective in protecting the Exchequer and levelling the playing field between direct employees and those who work in a similar manner to direct employees but through their own limited companies.

This document sets out a framework for those discussions and covers:

- The rationale for change;
- Options to improve the effectiveness of the rules; and
- Next Steps.

## Rationale for Change

Legislation was introduced in 2000 to tackle the avoidance of employment taxes by those who work through intermediaries, primarily their own company, often known as a Personal Service Company (PSC).

The government believes this is not working as effectively as it should be and non-compliance with the legislation is widespread. This is unfair as two people doing the same job, in the same way, can end up paying very different levels of tax depending on how they are engaged and this costs the Exchequer a significant amount each year. This cost will increase as the number of people working through PSCs continues to grow.

### The structure of the tax system

The UK system means that people pay different levels of tax depending on whether they work as employees, are self-employed or work through their own limited company. People who are self-employed pay a lower rate of National Insurance contributions (NICs) than employees reflecting historically lower entitlement to some state benefits, (although this has been significantly reduced by the recent reform of state pensions). People who work through their

own limited company can pay an even lower effective rate of tax and NICs than either the self-employed or employees. This is because of the interaction between allowances available and rates paid in the corporate and personal tax systems, and the absence of NICs on investment income, including dividends received from PSCs. This will continue to be the case following measures announced at the Summer Budget on the taxation of dividends.

There are many legitimate, commercial reasons for people to work through a company and for businesses to engage individuals in this way. The government recognises the benefits to the economy of having a flexible labour market and has no intention of stopping people from working in this manner

However, these differentials contribute to, and reinforce, the incentives for individuals to work through companies when they would otherwise be employees, and for businesses to engage individuals through companies, even if they are working in a similar way to their employees. It is this unfair manipulation of the rules that IR35 was introduced to address. These incentives to disguise employment by working through a PSC have increased over recent years as NICs rates and the Personal Allowance have increased and Corporation Tax rates have fallen.

Some stakeholders have told us that recent changes to tackle false self-employment and the use of offshore payrolls to avoid employment taxes have also added to the incentive for those looking to avoid employment taxes to work through PSCs to disguise their employment. As shown below, those who should but do not operate IR35, can unfairly gain a substantial tax and NIC advantage.

### **Case studies**

**Case study 1:** A legal company hires two lawyers in 2015-16 who do the same job and work on the same cases. The company pays the lawyers gross payments of £70,000 per year.

Jo works as a direct employee. The company deducts income tax and employee NICs from her salary and pays employer NICs on top. The total tax and NICs paid on Jo's salary is £30,612 (£22,071 by Jo and £8,541 by the company).

Ben works through a PSC and does not operate IR35. He pays himself the most tax advantageous remuneration strategy combining a low salary and dividends. His total tax and NICs liability is £16,900.

**Case study 2:** An NHS trust hires two nurses in 2015-16 and pays a total of £30,000 for each. The NHS trust does not want any additional costs and so, where the trust is liable to pay employer NICs, they negotiate a lower salary for the nurse.

Mark works as a direct employee. The NHS trust pays Mark a gross salary of £27,345 to account for the fact that they have to pay employer NICs. The total tax and NICs paid in relation to Mark is £8,316, and Mark's take home pay is £21,684.

Sarah works through a PSC and does not operate IR35. She pays herself using the most tax advantageous remuneration strategy and the total tax and NICs liability is £4,200 and takes home £25,800.

## The legislation

The intermediaries legislation – often referred to as IR35 – was introduced in 2000 and aims to tackle disguised employment. The legislation can be located [here](#) and [here](#).

IR35 requires individuals working through an intermediary to pay broadly the same tax and NICs as any other employees, where they would have been an employee if they were providing their services directly.

The legislation applies to a number of different types of intermediaries but most commonly applies where people provide their services through their own company, usually referred to as a PSC. While this document references PSCs throughout, the government would **welcome any evidence on the use of other types of intermediaries to which IR35 may apply.**

## Non-compliance with the legislation

There is a growing body of evidence which suggests there is significant non-compliance with the current rules.

The number of people paying tax under IR35 has remained fairly static since it was first introduced. However, there has been a substantial increase in the number of PSCs during the same period. The government estimates that there were around 265,000 PSCs in 2012-13, an increase of 65,000 on the previous year alone<sup>1</sup>. This number is expected to continue to increase.

Whilst many PSCs would not fall within the legislation because the worker would properly be regarded as self-employed, the government would still expect to see a larger increase in the number of people paying tax and NICs under IR35. In 2011-12 around 10,000 people paid tax under IR35, an estimated 10% of those who should have paid tax on at least part of the income their PSC receives under the legislation.

The Office of Tax Simplification's (OTS) review of IR35 as part of its review of Small Business Taxation published in March 2011 noted that the legislation is "little used", adding to the evidence that only a small number of PSCs are complying with the current rules. In response

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<sup>1</sup> There is no statutory definition of a PSC and they are not precisely identifiable in the available data. The government has estimated the number of PSCs using a proxy. It is therefore subject to a degree of uncertainty.

to the OTS' recommendations, the then Government asked HMRC to undertake a thorough overhaul of the administration of IR35. This work included improving its compliance approach to IR35. HMRC has recently strengthened its specialist compliance teams and increased the number of enquiries where IR35 is the main risk tenfold, and clarified the application of the rules to officeholders.

HMRC take a risk based approach to identify non-compliant cases so activity is targeted in the most cost effective way, concentrating on the high risk cases. However, carrying out IR35 interventions can be complex and time consuming.

One of the challenges is that responsibility for operating IR35 sits with the PSC itself and applies on a contract by contract basis. That means HMRC currently has to enquire into each individual PSC for each individual engagement, even where several PSCs are working for the same engager, often under what appear to be the same terms. Several parties may be involved in the contractual chain in each case and reaching agreement with all of them on their understanding of the contractual arrangements can be complex. There is also insufficient clarity concerning each party's responsibility for cooperation with HMRC interventions.

In April 2014, the House of Lords Select Committee on Personal Service Companies published their report which also expressed concerns about non-compliance with the rules. The report highlighted the industry which has grown up advising companies on how to ensure their contracts fall outside of the legislation and concluded that 'many individuals simply take a risk that Her Majesty's Revenue and Customs will not look into their employment status.'

Increasing HMRC's compliance response alone is not sufficient to tackle the size of the problem.

#### The Exchequer cost of non-compliance

Non-compliance with the IR35 anti-avoidance legislation is both unfair and costs the Exchequer a significant amount of revenue each year. The government estimates that noncompliance with the legislation will cost the Exchequer £430m in tax and NICs receipts this year and, without reform, it expects this loss to continue to grow.

There is also a risk that non-compliance will erode the behavioural impact of the current legislation, which would come at a further cost to the Exchequer. The deterrent effect of the legislation was estimated to protect around £520m of tax receipts in 2010-11.

This Exchequer risk, along with the growing cost of non-compliance, means there is a strong case for improving the effectiveness of the legislation.

### Additional Stakeholder concerns

As well as commentators noting the low levels of compliance with the legislation, they have also noted wider stakeholder concerns, in particular uncertainty and complexity in determining whether an engagement falls within IR35.

The government recognises these are areas of concern for many stakeholders and wants to work with stakeholders to ensure that any reform makes the rules simple and straightforward to comply with.

The government would **welcome further evidence from stakeholders on how Personal Service Companies currently operate IR35 and the issues that the rules create** for individuals and businesses across the market.

## Options to improve the effectiveness of the rules

### Framework for considering options for reform

As set out above and at the Summer Budget, the government believes the legislation in its current form is not working as effectively as it should and needs to be reformed.

Previously some commentators have suggested that IR35 should simply be abolished, but the government does not believe this is an option. The rules were introduced to tackle the avoidance of employment taxes by disguising employment and although the government recognises that there is a case to improve the way the rules operate, they retain fairness in the system and play an important role in protecting the Exchequer.

The government, therefore, wants to consider options to reform the legislation with the following objectives:

- The need to protect the Exchequer; and,
- Levelling the playing field between those who are employed directly and those who would be employed directly if they were not operating through their own company.

Making the legislation as straightforward to comply with as possible, and not creating disproportionate burdens on businesses or individuals will be core principles in designing any change. It is also not the government's intention to widen the scope of IR35.

It is envisaged that any change will be for tax and NICs purposes only, and will not affect the majority of employment rights.

The government would **welcome proposals for how to improve the effectiveness of IR35 that meet the objectives set out above.**

### Potential options

This is a complex problem and it is very difficult to create and enforce a system that addresses the problem of disguised employment which doesn't also have some impact on those who are genuinely self-employed and operating through a company for legitimate, commercial reasons.

During the last Parliament both the Office of Tax Simplification and the House of Lords Select Committee into Personal Service Companies published reports on IR35 which recognised there are no easy answers to reforming the legislation. Following both of these reports no consensus has been reached on the best approach to reforming the legislation.

One of the options for improving the operation of the legislation is to look at administrative changes. HMRC, along with the IR35 Forum, took action on this during the last Parliament culminating in a review of improvement to the administrative approach to IR35 which was published in January 2015 ([www.gov.uk/government/publications/ir35-forum-administrationreview-final-report](http://www.gov.uk/government/publications/ir35-forum-administrationreview-final-report)). Whilst this had some positive outcomes, it doesn't fully address the shortcomings of the current rules.

Another option could be to further improve HMRC's compliance response but, as set out earlier, the government does not believe this alone is sufficient to tackle the size of the problem as interventions focus on each individual engagement and often require input from several parties, not all of whom have a clear responsibility to cooperate with HMRC.

The government would, therefore, **welcome views on alternative options for more fundamental reform** which meet the objectives identified above.

One option which could meet the objectives for reform, and specifically tackle the challenges in enforcing compliance set out earlier in this document, would be for engagers to take on more of a role in ensuring that the right amount of employment taxes are paid. As now, the objective would be to ensure that where a worker would have been an employee if engaged directly, then the tax consequences would follow that.

Under such an arrangement, those who engage a worker through a PSC would need to consider whether or not IR35 applies (in the same way as they would need to consider whether a worker should be self-employed or actually be an employee), and, if so, deduct the correct amounts of income tax and NICs as they would for direct employees. However, the government recognises that this would increase the burden on engagers and would **welcome views on this potential option, including how it could be made as straightforward as possible for engagers to determine whether IR35 should apply as part of their routine hiring conversations.** Views would also be welcomed on:

- **whether such an approach would be effective in achieving the above objectives;**
- **whether there are particular sectors or types of engagers which would face particular challenges** e.g. large, geographically dispersed employers;
- **how such an approach should work where a PSC is engaged by an individual rather than another business, and if there should be different rules which apply in these circumstances;** and
- **any other views on the impacts of such a change and how they might be addressed to minimise any additional burden on engagers..**

Many stakeholders have noted the complexity associated with identifying whether or not IR35 applies as being an area of difficulty for some. Therefore, an element of any reform could be to simplify the test for determining if IR35 applies. One option could be to align the test with that used for temporary workers in the agency rules, which is based on supervision, direction or control. Another option could be to look again at some of the suggestions considered by the OTS, such as requiring an engagement to last a certain minimum amount of time to be considered one of employment. The government would **welcome views on the implications of a change in test, both positive and negative, and what stakeholders' preferred approach would be.**



The government would **welcome evidence and views on the potential reform options outlined above, along with any alternative options identified by stakeholders** which would meet the government's objectives set out in this document.

## Next Steps

The government welcomes views on the current IR35 system, and specifically on:

- Any evidence on the use of other types of intermediaries, aside from PSCs, to which IR35 may apply.
- Any evidence on how PSCs currently operate IR35 and the issues the rules create for individuals and businesses across the market.

The government also welcomes views on options for reform, and specifically on:

- Any proposals for how to improve the effectiveness of IR35 that meet the objectives outlined in this document.
- Any views on the potential option outlined in this document which would result in the engager taking on a greater role in being responsible for operating IR35, including:
  - Whether such an approach would be effective in achieving the objectives outlined in this document.
  - How it could be made as straightforward as possible for engagers to determine whether IR35 should apply as part of their routine hiring conversations.
  - Whether there are particular sectors or types of engagers which would face particular challenges.
  - How such an approach should work where a PSC is engaged by an individual rather than another business, and if there should be different rules which apply in these circumstances.
  - Any other views on the impacts of such a change and how they might be addressed to minimise any additional burden on engagers.

- Any views on the implications of a change in the test which determines whether IR35 applies, both positive and negative, and what stakeholders' preferred approach would be.

The government intends to use this stage of the consultation process to better understand the issues and explore options for reform, including what the impacts would be if engagers take more of a role in ensuring that employment taxes are paid correctly.

HMRC will be contacting a range of stakeholders who they expect to have an interest in developing options for reform, or would likely be affected by any change in this area.

If you would like to be involved in these discussions or to provide written views on this subject, please contact HMRC by email at [ir35.reform@hmrc.gsi.gov.uk](mailto:ir35.reform@hmrc.gsi.gov.uk). HMRC would welcome comments by the end of September 2015.

If the government decides to proceed with reforming the rules, any proposals will undergo a full consultation so that interested parties can contribute their views for consideration. The detail and timetable for further consultation will depend on the outcome of the discussions HMRC will have with stakeholders following publication of this discussion document.

## Confidentiality

Information provided in response to this discussion document, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

## Consultation principles

If you have any comments or complaints about the process please contact: Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ. Email: [hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk](mailto:hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk). Please do not send responses to the consultation to this address.