



HOUSE OF LORDS SELECT COMMITTEE ON
PERSONAL SERVICE COMPANIES
The Government's response

Presented to Parliament by the Chancellor of the Exchequer by
Command of Her Majesty

9 June 2014

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1. Introduction

- 1.1 The House of Lords Select Committee on Personal Service Companies was appointed on 12 November 2013 to consider the consequences of the use of personal service companies for tax collection. The Committee took extensive evidence from a wide range of stakeholders including HM Revenue and Customs (HMRC), professional bodies, representative bodies, public and private sector organisations, legal, financial services and accountancy professionals, other government departments and executive agencies, academics, trade unions and individual contractors.
- 1.2 Although the Committee's principal focus was on the use of personal service companies, it also considered wider labour market issues including the growing use of other types of intermediary arrangements such as umbrella companies, and their impact on individuals, the labour market, and the Exchequer.
- 1.3 The Committee's report, published on 7 April 2014, makes sixteen recommendations to HMRC, HM Treasury and the Low Pay Commission, relating to the use of personal service companies, a number of other intermediary arrangements and structures, and wider labour market issues. The recommendations relate both to operational and policy areas. This document is the Government's response to the report. Owing to HMRC's operational independence, matters relating to HMRC operational and administrative areas fall to HMRC, not ministers. The Government is grateful to the Committee for its analysis of these issues and has given careful consideration to its findings and recommendations.

2. Response to the Committee's conclusions and recommendations

- 2.1 The Government's response to the conclusions and recommendations of the House of Lords Select Committee on Personal Service Companies is set out below.
- 2.2 **We recommend that Her Majesty's Revenue and Customs carry out and publish a detailed assessment of the current Exchequer protection figure and of the costs that taxpayers incur in dealing with IR35. This should enable a better assessment of whether the legislation is having the intended effect and is proportionate. (Recommendation 1, paragraph 73)**
- 2.3 The Government is confident that the figure quoted for Exchequer protection from IR35, and the methodology used in the calculation of that figure, is robust. As acknowledged by the Committee in its report, the figure has been subject to extensive internal quality assurance. The Government reconfirms that the original Exchequer protection figure presented to the Committee of £475m was based on information available for 2008/09. The figure of £550m was submitted after updated information became available for 2010/11 and the lower limit of income above which people would switch to a personal service company, and the sectors in which it is prevalent, was updated. This update to the lower limit was based on intelligence from operational experts in HMRC.
- 2.4 However, the Government acknowledges that it could further clarify and amplify how IR35 figures have been calculated. Accordingly, appended to this paper is a note: *Estimating the cost of abolishing IR35*, which provides a more detailed analysis of the figures previously submitted to the Committee by HMRC. As this is not a new Budget Measure, the costing has not been scrutinised by the Office for Budget Responsibility (OBR).
- 2.5 As highlighted separately by the OBR, for example in their recent briefing paper: *Briefing paper No. 6: Policy costings and our forecast*¹, the yield from anti-avoidance measures is generally more uncertain than that from other policy measures. The main areas of uncertainty in this costing relate to the salary levels at which individuals would incorporate and the number of directors who would change their remuneration strategy in the absence of IR35. Emerging evidence, including that provided to the Committee by HMRC in arriving at the IR35 costing, indicates that those on lower salaries are incorporating and that the salary bracket used in the calculation for employees could therefore be further expanded.
- 2.6 HMRC will publish during autumn 2014 an updated administrative impact assessment note setting out the current administrative costs which taxpayers incur in dealing with IR35.
- 2.7 **Serial contracting is a feature of the modern British workforce and is supported by both businesses and contractors. We heard that although IR35 is not a significant issue for businesses, it can arouse considerable hostility from contractors.**
- 2.8 The Government recognises that many individuals choose to work through their own limited companies; sometimes referred to as personal service companies, and appreciates the positive contribution to the economy of those who choose to work for

¹ <http://budgetresponsibility.org.uk/category/publications/briefing-papers/>

themselves. However, people can also use intermediaries to disguise what would otherwise be employment income. The IR35 legislation seeks to ensure that what is properly employment income is taxed as such and tackles tax and National Insurance avoidance through the use of intermediaries.

- 2.9 HMRC accepts that there is a degree of hostility towards IR35 for a number of reasons, including that some of those genuinely carrying on a business and providing their services through a personal service company consider the legislation to be unnecessary and intrusive. HMRC will continue to work with the IR35 Forum to seek to raise contractors' awareness of IR35 and dispel perceptions that HMRC is targeting those genuinely in business providing their services through a personal service company.
- 2.10 **Moreover, we note that compliance with the rules can demand a great deal of time and effort on the part of contractors. We acknowledge that it can be difficult for individuals contracting through personal service companies to define their tax and National Insurance position quickly and accurately because of the contract-by-contract nature of IR35 and the need for a sound understanding of case law.**
- 2.11 Employment status is determined by the terms and conditions of the relevant engagement between an individual and engager. The contract-by-contract nature of IR35 is designed deliberately to reflect the fact that differing engagements can result in differing tax consequences.
- 2.12 HMRC will continue to work with stakeholders, in particular through the IR35 Forum, to identify how it can further streamline the operation of IR35 and support contractors to operate it correctly.
- 2.13 **We believe that the abolition or suspension of the IR35 legislation as proposed by the Office of Tax Simplification, whilst attractive, would be unwise if the legislation has the Exchequer protection effect claimed for it by Her Majesty's Revenue and Customs.**
- 2.14 The Government remains firmly of the view that the fiscal risk to the Exchequer of those incorporating to disguise employment income is significant. That view is based on the costings set out in the attached note.
- 2.15 **The current structure and rates of income tax and National Insurance provide an incentive for taxpayers to arrange their financial affairs in order to minimise the amount of tax and National Insurance paid. This has led to complex legislation, such as IR35, to counter such arrangements.**
- 2.16 The Government supports enterprise and those who choose to work for themselves, and believes that the tax system should continue to recognise the additional risk taken on by those who are genuinely in business for themselves.
- 2.17 However, the Government is also committed to reducing tax avoidance, including by the use of personal service companies, and to tackling areas of the tax system where avoidance behaviour is widespread or where there are opportunities to level the playing field in the tax treatment of compliant and non-compliant businesses.

- 2.18 As part of its ongoing compliance work, HMRC will continue to gather evidence about other forms of employment tax avoidance in order to inform future policy and operational decisions.
- 2.19 **Whilst we recognise the complexities in merging income tax and National Insurance and the effect that this may have on the contributory principle, we recommend that the Government re-examine the longer term case for combining taxes on income and National Insurance. (Recommendation 2, paragraph 89)**
- 2.20 The Government has looked at ways in which income tax and National Insurance could be more aligned. However, since employers are already adjusting to a significant number of reforms to payroll systems, the Government will wait for further progress on planned operational changes to the tax system before re-examining the operational integration of income tax and National Insurance.
- 2.21 **We acknowledge that businesses would generally resist being made responsible for IR35 assessment, finding the additional administrative pressure and liability as overly burdensome.**
- 2.22 The Government currently has no plans to make end client businesses responsible for IR35 where such businesses engage a personal service company.
- 2.23 **We recommend that Her Majesty's Revenue and Customs look again at whether they require complete and accurate responses to the "service company" questions on the personal tax return SA100 and the real time information employer year end declaration (formerly P35). (Recommendation 3, paragraph 98)**
- 2.24 Working with stakeholders, HMRC will undertake a full review of these questions on the personal tax return (SA100) and RTI end of year declaration: their form, purpose and clarity, with a view to making any necessary changes at the earliest practicable date.
- 2.25 **If Her Majesty's Revenue and Customs decide that they need the information from those questions, we recommend that their completion should be made compulsory, backed up by the potential for penalties to be charged for incorrect answers or non-completion. (Recommendation 4, paragraph 99)**
- 2.26 See response to recommendation 3 at paragraph 2.24.
- 2.27 **If Her Majesty's Revenue and Customs retain the questions, we recommend that they revise the guidance notes accompanying the personal tax return SA100 and the real time information year end declaration by employers to make the relationship to IR35 clearer. (Recommendation 5, paragraph 100)**
- 2.28 HMRC will include in the review referred to at paragraph 2.24, the relevant guidance accompanying the returns.
- 2.29 **If Her Majesty's Revenue and Customs decide that they do not need the information gained from the questions, we recommend that the questions be removed from the tax returns and declarations. (Recommendation 6, paragraph 101)**
- 2.30 See response to recommendation 3 at paragraph 2.24.

- 2.31 **Her Majesty's Revenue and Customs did not convince us that the resources currently allocated were sufficient to ensure compliance with the IR35 legislation.**
- 2.32 HMRC's compliance strategy is to support those who wish to comply voluntarily with their obligations, and concentrate direct interventions on those who deliberately bend or break the rules. HMRC focuses on the highest risk cases where the financial consequence of non-compliance can be substantial. This strategy is designed to reduce to the necessary minimum the administrative impact on taxpayers of compliance activity whilst effectively discouraging non-compliance.
- 2.33 The resource deployed to any area of risk in any year takes into account a number of factors, including the level of risk in an area compared to risks in other areas, the deterrent effect likely to be achieved, and administrative impact on the taxpayer population.
- 2.34 The use of a personal service company is not in itself indicative of tax avoidance and the Committee received significant evidence that individuals genuinely carrying on a business and operating through a personal service company support and contribute to the UK economy. In determining the resources deployed to IR35, HMRC considers all of the factors above and particularly the need to balance deterrent effect against the risk of affecting adversely the contracting sector.
- 2.35 In 2010/11 HMRC recognised that its deployment of resource to IR35 compliance did not sufficiently support voluntary compliance or deter non-compliance. Since 2011/12, HMRC has revisited its approach to the administration of IR35, including the resource deployed to supporting voluntary compliance and tackling non-compliance.
- 2.36 As explained to the Committee, as a result of HMRC's review, three new compliance teams were created in April 2012 and a fourth team has been put in place over the last year to further enhance HMRC's ability to respond to IR35 risk. There are now over 40 people who principally focus on IR35 risks. These staff are also able to draw on the expertise of other tax specialists if they need to. As a result of these changes, around 450 investigations have been opened over the last 2 years, with around 250 cases being worked at any one time.
- 2.37 HMRC will continue to keep under review whether the resources deployed to IR35 compliance are appropriate and aligned with its overall compliance strategy. As the Committee itself recognised, the use of intermediaries in the labour market, of which personal service companies are only one type, has grown substantially in recent years. Accordingly, future resources deployed to IR35 work and the number of investigations undertaken will be considered by HMRC as part of a wider review of how HMRC can most effectively ensure compliance with employment taxes where individuals' services are provided through intermediaries.
- 2.38 **We recommend that Her Majesty's Revenue and Customs articulate with greater clarity the costs they incur from IR35 compliance efforts and administration and the relationship between those costs and the overall yield gained from the legislation. (Recommendation 7, paragraph 113)**

- 2.39 The fact that HMRC has concentrated IR35 compliance work in specialist teams enabled HMRC to provide a very broad estimate of the cost of those teams. A more detailed administrative costing is not able to be provided because these compliance staff undertake some non-IR35 work and receive support for their IR35 work from staff outside of the teams, for example from technical specialists.
- 2.40 The main purpose of IR35 is to deter people from disguising employment income through the use of intermediary arrangements. Accordingly, in HMRC's view, the effectiveness of its compliance activity cannot be measured solely by a comparison of compliance costs (to the extent that those can be identified accurately) to any direct yield recovered.
- 2.41 **We conclude that many individuals simply take a risk that Her Majesty's Revenue and Customs will not look into their employment status, an attitude that is fostered by the decreasing number of compliance investigations.**
- 2.42 HMRC's compliance strategy aims to support voluntary compliance so that compliance investigations can be focussed primarily on the wilfully non-compliant. The number of investigations that HMRC undertake is therefore only one aspect of its compliance activity. HMRC continues to improve its risk profiling to enable it to better identify high risk cases.
- 2.43 Inevitably some taxpayers will choose to take the risk that they will not be subject to investigation. However, for those who are non-compliant, the consequences of investigation can be financially substantial with the payment of tax, interest and penalties, and in the most serious cases, criminal prosecution.
- 2.44 As with all HMRC's compliance activity, the number of investigations into employment status and various types of intermediaries, including personal service companies, is kept under review. HMRC will consider the number of investigations into employment status and intermediaries as part of the wider review referred to at paragraph 2.37.
- 2.45 **We recommend that the Contract Review Service be publicised to greater effect, that Her Majesty's Revenue and Customs investigate ways to encourage individuals to use the service and that they look into ways to bolster confidence in its independence and impartiality. (Recommendation 8, paragraph 123)**
- 2.46 The IR35 Forum was set up in 2011/12 as part of a wider review by HMRC of the administration of IR35. Working with HMRC, the Forum is now looking at how the revised administration arrangements have worked and what further improvements can be made. That work includes a review of the Contract Review Service; its use and barriers to its use, and will report and make recommendations to the IR35 Forum during 2014. The Committee's recommendations will be considered by HMRC as part of this review.
- 2.47 **We accept that the guidance will never be able to give absolute certainty to taxpayers of their status in relation to IR35 but we agree that the current guidance is far from satisfactory.**
- 2.48 HMRC acknowledges that the IR35 guidance can be improved. A comprehensive review of the guidance has taken place during which HMRC worked closely with stakeholders to understand user needs. The new guidance will be published shortly. HMRC is committed to keeping the guidance under review to ensure that it remains up to date and responsive to user needs.

- 2.49 **We recommend that Her Majesty's Revenue and Customs undertake a full consultation on how the Business Entity Tests could work better to provide greater certainty for taxpayers. (Recommendation 9, paragraph 134)**
- 2.50 A review of the Business Entity Tests forms one strand of the wider review of IR35 administration referred to at paragraph 2.46. HMRC is working on this strand with members of the IR35 Forum to gauge the use and impact of the Business Entity Tests and will report and make recommendations to the IR35 Forum during 2014.
- 2.51 **We commend the motive behind establishing the IR35 Forum as an opportunity for wider stakeholder engagement.**
- 2.52 HMRC has found the IR35 Forum extremely useful and helpful and is committed to continuing to work with the Forum and wider stakeholders to look for ways to improve the administration of IR35, supporting improved customer service and ensuring compliance.
- 2.53 **We recommend that Her Majesty's Revenue and Customs go to greater lengths to demonstrate that they are receptive to the feedback that is provided through this group and that they review the breadth of membership. (Recommendation 10, paragraph 140)**
- 2.54 HMRC is committed to working with the Forum, values the feedback the Forum provides, and will look for further ways to demonstrate it is receptive to this feedback. HMRC is also looking at membership of the IR35 Forum as part of the wider review of IR35 administration and will report and make recommendations to the IR35 Forum during 2014.
- 2.55 **We are concerned that, in some sectors, individuals who are providing their services through personal service companies or, more often, umbrella companies and agencies, have a limited awareness of how they have been engaged to provide their work and who it is that has engaged them. This may mean that the individuals are not aware that they have foregone at least some levels of employment protection and benefits to which they would be entitled if they were in conventional employment. We recognise the complexity of the subject matter, and of the case law underpinning some of the distinctions made, but believe that it ought to be possible to present these issues in a concise and understandable manner.**
- 2.56 The Government recognises the issues raised by the Committee concerning the engagement of low paid workers through intermediary structures such as umbrella companies and personal service companies.
- 2.57 HMRC currently works with colleagues across Government, including the Department for Business Innovation and Skills, the Gangmasters Licensing Authority and the Security Industry Authority to identify how labour is engaged and paid and the extent to which current engagement practices result in workers being unclear about their employment status and the full implications of how they are engaged and paid.
- 2.58 The Government recognises the challenge to provide clear and easily accessible guidance and advice to temporary workers, the majority of whom rely on advice given by the businesses that place and pay them.

- 2.59 The Pay and Work Rights Helpline provides workers with the ability to notify HMRC, in confidence, where they are concerned about engagement practices and pay; for example non-compliance with the national minimum wage.
- 2.60 The Government is committed to increasing compliance with minimum wage legislation and its effective enforcement, and actively targets employers who flout their responsibilities. HMRC investigates any complaints made against employers through the Pay and Work Rights Helpline, taking civil and criminal proceedings as necessary. HMRC also carries out risk based enforcement using intelligence and other information received from third parties and other enforcement agencies.
- 2.61 Following growing evidence of the movement of permanent workers from payrolls into intermediaries which classed the workers falsely as self-employed, the Government has taken steps to tackle the issue of false self-employment through the use of intermediaries by introducing anti-avoidance legislation in the Finance Bill 2014. Amongst other things, this legislation reduces substantially the number of workers who were being denied a range of contributory benefit entitlements.
- 2.62 The Government will continue to monitor trends in the number of individuals operating through intermediaries, including personal service companies. HMRC will continue to work with, amongst others, the Department for Business, Innovation and Skills where intermediaries and engagement practices are identified which appear to deny workers' rights, including national minimum wage rights, in order to identify how best to ensure that workers have easily accessible information on the implications of how they are engaged and paid.
- 2.63 **We recommend that the Government should develop and publish a short guide setting out the basic differences between employment and self employment. The guidance should be published across multiple platforms, including both digital and paper, and should be made available to individuals working in all industries where intermediaries are prevalent. (Recommendation 11, paragraph 164)**
- 2.64 HMRC has recently updated its guidance on employment status, and provides an Employment Status Indicator tool, both of which are accessible online. Two factsheets (*ES/FS1 Employed or self-employed for tax and National Insurance contributions*² and *ES/FS2 Are your workers employed or self-employed for tax and National Insurance contributions*³), are also available online.
- 2.65 Following the publication of the Government's Digital Strategy in November 2012, HMRC published its Digital Strategy in December 2012. It outlines how HMRC will become a 'digital by default' organisation, moving towards a set of customer-focused digital services which are so straightforward and convenient that all who can use them will choose to do so whilst those who cannot are not excluded. Some people will always need to write to HMRC or speak to HMRC on the phone, but many straightforward enquiries or transactions can be dealt with online, freeing up resources to deal with more complex enquiries or to support those who can't use digital services.
- 2.66 HMRC will continue to work with the Department for Business, Innovation and Skills to review how worker awareness can be raised and cross-governmental guidance can be further enhanced, updated as part of the planned transition to gov.uk, and more widely disseminated.

² <http://www.hmrc.gov.uk/leaflets/es-fs1.pdf>

³ <http://www.hmrc.gov.uk/leaflets/es-fs2.pdf>

- 2.67 **We recommend that the Government includes within the remit of the Low Pay Commission a consideration of the use of personal service companies and umbrella companies by lower-paid workers, and the implications for pay, employment rights and statutory entitlements. (Recommendation 12, paragraph 172)**
- 2.68 The Low Pay Commission's goal is to recommend levels for the minimum wage rates that will help as many low-paid workers as possible without adverse impact on their employment prospects. The remit of the Low Pay Commission for 2015 will be published over the summer of 2014.
- 2.69 **As it is clear from the evidence that abuse of the expenses dispensations operated by umbrella companies is taking place, we recommend that Her Majesty's Revenue and Customs ensure that enforcement action is taken to end these abuses and to ensure that expenses dispensations are managed correctly. (Recommendation 13, paragraph 181)**
- 2.70 A substantial number of temporary workers are now employed through umbrella companies. Many umbrella companies are compliant with their obligations but HMRC is aware that some are non-compliant, including through the misuse of dispensations issued by HMRC.
- 2.71 The circumstances in which HMRC is obliged to grant a dispensation are set out clearly in legislation: HMRC must grant a dispensation where it is satisfied that the expenses to be paid under that dispensation would qualify for tax relief. As part of the wider review of how HMRC can most effectively ensure compliance with employment taxes through the use of intermediaries referred to at paragraph 2.37, HMRC will consider how to tackle non-compliance by umbrella companies. This will include the misuse of dispensations.
- 2.72 **We also recommend that Her Majesty's Revenue and Customs should review its processes for granting and renewing expenses dispensations, in order to ensure that potentially high risk organisations are granted dispensations only when appropriate. (Recommendation 14, paragraph 182)**
- 2.73 At Budget 2014 the Government announced that it would be consulting on the Office of Tax Simplification's recommendation that the dispensations regime should be replaced with an exemption for qualifying business expenses to reduce the administrative burden on employers paying expenses and to give them a greater degree of flexibility. As part of that consultation, which is due to take place over the summer, the Government would like to better understand how any reform would affect particular industries, business models and types of organisations.
- 2.74 **We acknowledge that there will be circumstances in which public sector organisations, just like private sector organisations, may need to acquire services from those who operate through personal service companies. For this reason, we believe that any blanket restriction on public sector use of personal service companies would not be beneficial to the delivery of public services.**
- 2.75 The Government has no plans to introduce a blanket restriction on the public sector use of personal service companies.
- 2.76 **The Treasury Review of off-payroll appointments provided only a limited assessment of the extent of such engagements; large areas of public service**

provision, such as local government and some health services, were not included in its scope.

- 2.77 The Government is committed to tackling tax avoidance and evasion and ensuring that everyone pays their fair share of tax. It is essential that Government departments are able to assure themselves that their off-payroll workers are meeting their tax obligations.
- 2.78 In May 2012 the Chief Secretary to the Treasury published the *Review of the tax arrangements of public sector appointees*⁴. The scope of the review was all bodies covered by HM Treasury's *Managing Public Money* guidance (MPM). This includes central government departments, arms length bodies, trading funds and non-departmental public bodies, including NHS trusts and non-maintained schools.
- 2.79 The review concluded that public spending guidance and tax law set out clearly that those engaged off payroll should not seek to reduce artificially their tax payments. Arrangements set up to explicitly avoid tax are forbidden under MPM. However, it noted that departments did not currently have the right to assure themselves that those who are off payroll are meeting their tax and National Insurance obligations. It also concluded that for short term contractors the potential for assurance needs to be balanced against additional burdens placed on departments and contractors.
- 2.80 The review recommended that all board members and individuals with significant financial responsibility should be on the payroll, unless there were exceptional circumstances, which should last for no longer than six months, and that all individuals earning over £220 per day and engaged for over 6 months should have provisions included within their contracts allowing the department to seek assurance that they were meeting their tax obligations.
- 2.81 **We recommend that the Government carry out an assessment of the extent to which off-payroll engagements are used elsewhere in the public sector, including by those earning less than £58,200 per annum. (Recommendation 15, paragraph 210)**
- 2.82 The review went further in requiring that departments should determine whether it was appropriate to seek assurance from individuals earning less than £220 per day or who had been engaged for less than six months. Departments are free to take a risk-based approach to all such appointments, and are not required to seek assurance on those appointments they regard as low-risk. This is a proportionate and cost-effective way of managing this process.
- 2.83 **As the guidance embodied in Procurement Policy Note 07/12 currently appears to be applied inconsistently across departments, we recommend that Her Majesty's Treasury take a leading role in ensuring consistency of application and that it should go to greater lengths to monitor the implementation of the Procurement Policy Note 07/12 guidance across Government departments. (Recommendation 16, paragraph 226)**

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https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220745/tax_pay_appointees_review_230512.pdf

- 2.84 Cabinet Office and HM Treasury have published guidance on the assurance process and required departments to detail their implementation of these recommendations in their end of year accounts. HM Treasury released a review of compliance with these recommendations in March 2014.
- 2.85 By reporting this information in departments' end of year accounts, it is clear that Accounting Officers, in accordance with their wider responsibility for managing public money, are responsible for ensuring that the information is correct and that the risk of tax avoidance by off payroll workers that they have engaged is minimised. Departments are able to seek guidance from HMRC and HM Treasury as required.
- 2.86 HM Treasury's March 2014 review found that departments sought assurance on the tax affairs of 1,940 of their contractors, and received satisfactory assurances from 1,815 of these engagements. In 125 cases contracts were terminated or came to an end before assurance was received. Where this occurred, departments have since referred all individuals to HMRC and this intelligence has been considered as part of HMRC's wider risk assessments.
- 2.87 The Department of Health has conducted a survey of NHS organisations and are working with Monitor and the NHS Trust Development Authority to address areas of concern. The Department of Health plans to give an update on its progress in due course.
- 2.88 The Department for Education has included provisions within its guidance for Academies that stipulates that 'Academy trusts must ensure that their senior employees' payroll arrangements fully meet their tax obligations and must comply with HM Treasury's guidance on this matter regarding the employment and contract arrangements of individuals on the avoidance of tax'.
- 2.89 Local Government and the Devolved Administrations are outside the scope of MPM. However, the Secretary of State for Local Government wrote to the Local Government Association to highlight the issue and has published guidance which makes clear that local authorities should actively review their approach to the remuneration of senior appointments. The Chief Secretary to the Treasury has written to the Devolved Administrations in similar terms.

Annex 1. Estimating the cost of abolishing IR35

Description

This note estimates the cost to the Exchequer of abolishing IR35.

Where people work through their own company, they have a number of options for how they withdraw the profits from their company: this may be as dividends, as employment income or a mixture of the two. Where IR35 applies, all the income paid to the company as a result of work under that contract is deemed to be employment income. This means that they have to pay employer National Insurance, employee National Insurance and income tax on all of the income from that contract.

Direct costing

Tax Base: We have profiled the end of year return (P35) in 2010-11 which shows that approximately 6,000 people tell us that they operate through a service company and are applying IR35.

The direct cost to the Exchequer is the difference between tax paid on salary taken from the company (where IR35 applies) and tax that would be payable if the individual adopted the most tax efficient remuneration strategy in the absence of IR35.

Direct Exchequer impact 2010-11	£30m
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Behavioural costing

This is split into two components, the behaviour of directors and the behaviour of employees.

Directors

Tax Base: We have profiled current directors with both employment income and dividend income who extract 50% or more of their income as dividends. We have assumed that 40% of them would change their behaviour in the absence of IR35. This gives a population of approximately 220,000 directors.

This assumption is consistent with intelligence from operational experts in HMRC.

The cost to the Exchequer is the difference between tax paid on income and tax that would be payable if the individual adopted the most tax efficient remuneration strategy in the absence of IR35.

Employees

Tax Base: We have profiled current employees' salary levels using the 2010-11 Survey of Personal Incomes, the latest available data at the time the costing was refreshed for the House of Lords Select Committee on Personal Service Companies. We have assumed that 4% of all current employees earning above £50,000 would incorporate in the absence of IR35. This gives a population of approximately 55,000 individuals.

This assumption is consistent with intelligence from operational experts in HMRC. It is further supported by:

- Analysis of the estimated effect on levels of incorporations following the change in corporation tax (CT) rates in the early 2000's (35,000 in the first year), and a peak of 45,000 in the year prior to the introduction of legislation on Managed Service Companies. As employees' behaviour is more directly impacted by IR35 than by CT rate changes, the above estimate of 55,000 appears reasonable.
- Research based on 2007-08 data from the Survey of Personal Incomes conducted on behalf of the Office of Tax Simplification (OTS) in 2011. This research assumed that around 30,000 employees would incorporate following a suspension of IR35. This equates to approximately 1.8% of individuals with employment income between £50,000 and £150,000 in 2007-08. The OTS acknowledged the difficulty in estimating the size of the personal service company population, which both HMRC and OTS have assessed to be rising, and that it is only possible to make illustrative calculations. These factors taken together are consistent with the estimate based on HMRC operational intelligence.

The cost to the Exchequer is the difference between tax paid on salary and tax that would be payable if the employee incorporated and adopted the most tax efficient remuneration strategy in the absence of IR35.

Behavioural Exchequer impact 2010-11	
Directors	£115m
Employees	£405m
Total	£520m

Total costing

Total Exchequer Impact 2010-11	
Direct Exchequer impact	£30m
Behavioural Exchequer impact	£520m
Total	£550m

Areas of uncertainty

The main areas of uncertainty in this costing relate to the salary levels at which individuals would incorporate and the number of directors who would change their remuneration strategy in the absence of IR35. These behavioural assumptions are inherently difficult to estimate.

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