

Estimating the Administrative Burden of IR35 and the cost of abolishing it

Description

In response to the recommendations of the House of Lords Select Committee on Personal Service Companies, HMRC committed to publish an estimate of the cost to the Exchequer of abolishing IR35 and an updated administrative impact assessment note setting out the current administrative costs which taxpayers incur in dealing with IR35.

An estimate of the cost to the Exchequer of abolishing IR35 was published on 9 June 2014 as an annex to the Government's response to the recommendations. This document incorporates that annex and expands it to include an assessment of the administrative burden of IR35 on taxpayers.

In summary, HMRC estimates that the **annual administrative burden of IR35 is £16m** and the **cost to the Exchequer of abolishing it is £550m**. The Government remains firmly of the view that the administrative burden of IR35 is proportionate when considered against the fiscal risk to the Exchequer of those incorporating to disguise employment income. HMRC has done significant work in recent years to improve the administration of IR35, in particular by working with stakeholders on the IR35 Forum.

Further information about how the above estimates were calculated is set out below.

Estimating the cost 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.

Estimating the Administrative Burden of IR35

The administrative burden is defined as the cost to business of disclosing information to HMRC or to third parties. The cost measured here is the additional burden caused purely by the IR35 legislation, and not the 'business as usual' costs. Another way of putting this is that we are measuring the cost to business that would fall away if the IR35 legislation were abolished overnight.

The administrative burden does not cover one-off or transitional costs of change, the amount of tax paid, HMRC's own costs of administering IR35, cash flow costs etc. It also does not include administrative costs incurred when things don't work smoothly, for example, when businesses make errors on forms or have to contact HMRC.

The basic formula for an obligation is: Admin Burden = *Price x Quantity*

Price is the cost to a business of complying with an HMRC obligation, whether this is the cost of own staff time, the cost of paying an agent, the cost of buying items needed to disclose information (such as postage or tax software), or a combination of all three.

Quantity is the number of times per year the HMRC obligation is met. This is a function of the number of businesses that comply and the number of times they are required to comply per year.

Using this methodology **we estimate that the annual administrative burden of IR35 is £16m**. This is made up of two obligations which are discussed in more detail below.

Obligation 1: Understanding the IR35 legislation and ascertaining whether it applies

From analysis of 2011-12 company returns we estimate that there are approximately 200,000 active one-director companies with zero or one employees.

The majority (75%) of these companies use an external accountant. Evidence from members of the IR35 Forum, as well as our own research, shows that the majority of accountants include IR35 tax advice and contract reviews within their fees. Therefore we expect that this obligation will be met by their accountant. The accountant will spend time ascertaining whether IR35 applies, and we have used the hourly rate for chartered and certified accountants from the ONS 2013 Annual Survey of Hours and Earnings¹ (to which a 30% uplift for overheads (such as pension, NI contributions) has been added) to calculate the cost of this time.

The minority (25%) of companies without an external accountant will spend some of their own time on this obligation and may also consult an in-house accountant. To calculate the cost to these companies we have used evidence provided by members of the IR35 Forum of the time taken for this obligation (including any time spent seeking advice from any trade organisations or membership bodies) and the typical hourly rate for a contractor. We have also used the same hourly rate for chartered and certified accountants as above.

Understanding the IR35 legislation and ascertaining whether it applies	£15.8m
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Obligation 2: Working out the deemed payment

We have profiled the end of year return (P35) in 2011-12 which shows that approximately 12,000 people tell HMRC that they operate through a service company and are applying IR35.

As for obligation 1, the majority of these companies will use an external accountant. We have estimated the time taken by the external accountant and used the same hourly rate for chartered and certified accountants as above to estimate the cost of meeting this obligation. For the minority without an external accountant we have again used evidence provided by members of the IR35 Forum to estimate the time taken and typical hourly rate for a contractor.

Working out the deemed payment	£0.2m
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Total Administrative Burden

Total Administrative Burden 2011-12	
Understanding the IR35 legislation and ascertaining whether it applies	£15.8m
Working out the deemed payment	£0.2m
Total*	£15.9m

* The sum of the obligations does not equal the total due to rounding.

Other considerations

In calculating the burden of the two obligations above on those companies with an external accountant, we have included the cost of their accountant's time. If IR35 were abolished we expect these companies would retain their accountant, in line with the proportion of all companies who use accountants. Therefore we have included only the cost of the accountant's time spent on each obligation, rather than the total fee of the accountant. The reduction in cost incurred by the accountant may not be passed on to the company.

If IR35 did not exist, some companies may choose not to operate monthly payroll as the directors have alternative sources of income. For these companies, operating payroll is therefore an additional administrative burden caused by IR35. On the other hand, some companies who currently do not pay dividends may choose to do so if IR35 did not exist. For these companies, reduced accountancy fees associated with not paying dividends is a reduction in administrative burden caused by IR35. We estimate that these competing costs approximately balance.

¹ <http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings/2013-provisional-results/index.html>