

Off-payroll working in the Public Sector: Reform of the Intermediaries Legislation

Response by the Office of Tax Simplification

1. Introduction and summary

- 1.1 The focus of the OTS is simplification of the tax system. That encompasses two broad arms: technical simplification (simplifying the legislation and rules) and administrative simplifications (making the tax system easier to deal with). An important component of the latter is delivering certainty: a system that gives certain outcomes is easier to deal with. We therefore support the aims of this reform to provide greater certainty and clarity on the intermediaries' legislation.
- 1.2 However, we have concerns that the proposals within this consultation will not, overall, deliver simplification. We fully accept that wider policy considerations have to be taken into account but aspects of the proposals do introduce additional complexity. We note, for example:
- the need to request information to help determine status, which will add administration;
 - the status test results may not be binding, and so lack certainty;
 - possible boundary issues and market distortions between private and public sector.
- 1.3 The consultation mentions the use of a new digital tool, which reflects in many ways the recommendations in the OTS's Employment Status report¹ for an enhanced Employment Status Indicator. We naturally support this idea but would caution that
- such a tool will only deliver simplification if there are clear rules and procedures around gaining certainty for the outcome;
 - it will naturally need testing in practice but that testing should consider whether, as the OTS suggested, it might be better to have two versions of the ESI to cater for differing situations/businesses;
 - the tool will also need to be kept up to date.

2. The Office of Tax Simplification

- 2.1 The OTS is an independent office of HM Treasury, established in 2010 to provide independent advice to Ministers on ways of simplifying the UK tax system. In developing our recommendations, we carry out extensive evidence gathering from all those involved with the tax system – businesses large and small, individuals, representative bodies, advisers and HMRC. Our recommendations cover both technical and administrative aspects of the tax system.

¹ OTS Employment Status Review – March 2015 (<https://www.gov.uk/government/publications/employment-status-review>)

2.2 The OTS is being placed on a statutory basis in FB16 with an expanded remit. As well researching specific areas of the tax system as requested by Ministers, our new remit now puts greater onus on the OTS to actively seek areas of complication and responding accordingly. And it is in that context that we comment on this consultation.

3. Responses to the consultation questions

3.1 We will only comment on a selection of the consultation question – those that have a clear simplification ambit. Further detailed comments on the online digital tool are in an Annex to this paper.

Questions 3 & 4: Should private companies carrying out public functions for the state be included? Are there any public bodies caught by this definition who would face particular impacts which should be considered?

3.2 Our main concern is that the definition and dividing line is clear, easy to manage and well understood by those who have to deal with them. We can see that including private companies carrying out public work could cause problems and confusion and so from a simplification point of view would answer ‘no’ to question 3. There would need to be a clear and understood list of public bodies that have to operate the proposed rules, with an obligation to ensure their potential contractors understand their position.

3.3 More widely, we have been told by some correspondents about the risks of creating unfair differentials between private and public sector organisations, making it more difficult for public sector organisations to hire specialist help and creating a distortion in the market. This would occur where there is direct competition (e.g. in broadcasting); we have also received feedback from the museum sector where some museums would be within the definition under the FOI but other museums would not be. This is beyond our simplification brief but we have to note the point.

Question 5: Are rules needed to ensure that engagers have the information they need to make the decision? If so, what should they be?

3.4 Rules will be needed so that the business that has taken reasonable steps to obtain the information can transfer the liability to the business that has failed to provide the information.²

Questions 6 & 7: the 5% allowance

3.5 From a pure simplification point of view, retaining the 5% allowance on payments where someone working through a PSC and is treated as subject to PAYE/NIC is illogical and a complexity. Simplicity would dictate that it would be abolished as far as the engager is concerned and any such rule was solely for the PSC to claim/operate.

VAT

3.6 We note there is no question posed about VAT. We have concerns that the treatment outlined in the document – effectively treating some PSC users as employees for PAYE/NICs but still as registered traders for VAT for the services provided – adds complexity and has the

² A good example of a requirement for “reasonable steps” to be taken to obtain information is in s.14 Agency Workers Regulations 2010

potential to cause confusion. Surely it would be simpler for a single test to be applied: that the PSC user is or is not under the new PAYE/NIC rules for a particular engagement? If they are, then they are treated as an employee and no VAT arises on their services. Having someone treated as an employee yet still having to charge VAT has overtones of the tax system having its cake and eating it; it also adds further to public sector costs given that in many cases the engager may not be able to recover the VAT charged.

Questions 9 – 13: the tests and the on-line tool

- 3.7 Respondents to the Summer 2015 Discussion Document on the intermediaries legislation said that to operate the rules they would require tests that were simple to use and understand and to give organisations certainty on the status of a worker from day one.
- 3.8 In this consultation, HMRC have proposed that there is a new gateway process that will quickly weed out those that are not within scope of the rules. In order to do this, however, the organisations involved, be it the agency or the end-engager, may need to obtain details from the PSC, including whether materials are supplied as part of the contract and whether the worker is being supplied through a limited company. In any test where one party will need to consult another, there is an admin burden and unless there is an incentive to answer the question, it is likely to go unanswered³.
- 3.9 It is clearly best from a simplification point of view to design a set of questions that require straightforward, objective 'yes/no' answers (e.g. Qs 1, 2 & 4). Q3, however, will require a quantification and may also require verification from another party, so it is less simple to use.
- 3.10 The first two parts of the test do not give certainty as the decision provided is not binding. We appreciate that the difficulty is that a status decision is based on the information one has at the time, so even if it gave certainty on day one, it may not apply if there is a material change to the contract, which the engager and/or the contractor may not be aware of.

Question 14: Where should the liability for tax and National Insurance (and penalties and interest where appropriate) fall when the rules haven't been applied correctly?

- 3.11 As noted, a regular theme of comments to the OTS from stakeholders is the need for certainty. One important facet of that is the taxpayer – employer or individual – is protected against penalties and unexpected liabilities when they have operated the tax system properly and complied with their responsibilities.
- 3.12 It is clearly necessary for any tax rules to be supported with penalties and interest but the results need to be fair and simple. So these new rules need to have clear and simple procedures to enable an engager to be sure that they have operated them properly and are not at risk of penalties.

³ This is the experience of taking reasonable steps under the AWR 2010, where it is reportedly very difficult to get the requisite information.

4. Reform of the Intermediaries legislation: some general comments

- 4.1 In the OTS's Small Business Tax Review - Interim Report (March 2011)⁴, we reported that "it is clear that in many other instances IR35 as it stands is not effective, either for the individuals affected or for the Exchequer." Our recommendation was for the IR35 rules to be suspended; our alternative was for the introduction of tests that would allow the taxpayer to self-assess their position with certainty.
- 4.2 The idea of suspension was rejected due to risk. Instead, the OTS's recommendation for an overhaul of the administration of this area of the tax system was followed, together with developing the tests into what became the Business Entity Tests. Although these were later scrapped, we still think the approach is correct as it has the potential to focus on providing pre-transaction clarity and certainty, and restoring trust.
- 4.3 We note with interest the recent research report conducted by HMRC⁵ that the potential changes proposed in the intermediaries' legislation were not supported by business overall. This is perhaps unsurprising in that they feared additional tax costs, but it is important to note that they had a key concern regarding undermining the business and their relationship with the freelancers/contractors. Many of the businesses used temporary staff and considered them to be central to the success of their business, primarily because of the flexibility and skills they provided.
- 4.4 We assume that this proposed legislation will be carried through. However, we think there is a need to keep this whole area of how the flexible workforce engages with the tax system under review. We think this is particularly necessary with the rise of the gig/sharing economy⁶. **We think that a review focusing specifically on the taxation of the flexible workforce should be considered.**
- 4.5 On a wider note there are various other measures that have just been introduced into the tax system which are likely to affect the same population of taxpayers, notably the dividend tax and the new rules on travel and subsistence. Case law in the employment rights area continues to develop. Either as part of or in parallel to the idea in the previous paragraph, **there needs to be a project to try to develop a simpler test that can provide binding certainty taking into account both tax and employment status. Again, this could be part of the remit of the Cross Government Working Group on Employment Status.**
- 4.6 Finally in this section, we note that we have used the term "Personal Service Company" or "PSC" because it has been used throughout the consultation document. Although it is a term that it is regular use and is probably generally understood, it is not a term that has been defined by statute or one that has an accepted or agreed definition. We think it would be useful for **the Cross Government Working Group on Employment Status to develop a definition of the term Personal Service Company** to ensure that all involved have a definite common understanding. This could build on the comments in the House of Lords Economic Affairs Committee's report on the area.

⁴ At paragraph 5.8

⁵ HMRC Customer Insight & Knowledge Team - Intermediaries Legislation Qualitative Research – To understand the implications for employers/engagers, if they were given responsibility for operating the Intermediaries legislation – July 2016 (The research was undertaken by Ipsos MORI)

⁶ The OTS will be publishing a paper on the gig economy next month.

Annex - Detailed comments on the outline digital tool

1. Diagram 2 appears to show that if the public sector organisation hires the worker through an agency, they do not have to consider the rules, that is the responsibility of the agency alone. The agency will then have to consider whether 20% or more of the contract is for materials consumed in service. It is not clear how this part of the test will work in practice. How does the agency decide what is 20% of the contract, or indeed, how does the PSC decide and this appears to be based on materials that are consumables, not for equipment used to provide the services. This part of the test is likely to cause significant difficulty for the agency to make a decision on and is far from a simplified test. It is not clear how the other three questions bear any relevance to establishing employment status.
2. The question on materials, at first instance, looks like HMRC is using the 'equipment' test but, this test does not appear to be whether you provide your own equipment or not but, whether materials are used as part of the job.
3. It is unlikely that the gateway process will weed out any of the PSCs whose services are based on knowledge, regardless of whether they provide their own equipment because they will not pass the 20% test. So a defined population of contractors working in the public sector who provide services based on their knowledge, through an agency will move to the second part of the test.
4. A two-part test, in itself, adds complexity and it will be difficult for the agency to answer the second part of the test without getting answers from the engager or the PSC.
5. The second part of the test has two further questions. Unlike existing legislation, the consultation document has departed from the test of supervision, direction and control and has added two new questions based on employment status case law, these are:
 - **Right to personal service** – Is the worker required to do the work themselves?
 - **Control** – Does the engager decide or have the right to decide how the work should be done?
6. If the engager cannot answer 'yes' (in which case PAYE should be applied) or 'no' (in which case PAYE should not be applied) to both questions, they will have to use yet another test in the form of a digital tool. This seems to add unnecessary complexity, to use a three part process and to have to contact another party (either the agency, engager or the PSC) to get additional information.
7. The questions in part one are:
 - Is the organisation from the public sector?
 - Is the worker hired through an agency?
 - Is 20% or more of the contract for materials consumed in the service?
 - Does the worker own their own company?
8. The questions in part two are:
 - Personal service/substitution
 - Control
9. Part three: Is to use the digital tool that is currently being developed by HMRC.

10. The OTS sees the three part test as an unnecessary complication that will be a burden on business. We note that question 3 of the first part of the test is not a 'yes' or 'no' answer as it has to be quantified. It is difficult to comment further, however, as it is not clear whether the agency would be in the position to quantify whether the consumable materials make up 20% of the contract.

11. *Q. 5 - Personal Service*
 What is inherent in a contract of employment is that the worker has to perform the job personally. This has been translated into the absence of a substitute meaning that it must be an indication of employment but, this is not necessarily true. Where the worker is a professional person⁷, an expert or experienced and highly skilled contractor, their services would not be substituted because it is specifically their skills that are required but, this is not necessarily an indication of employment. The fact that an individual cannot substitute themselves may also be due to issues of security which, in the public sector, is particularly relevant but, again, is not necessarily an indication of employment. The employment status test which is made up of case law is a system which flexes depending on the type of worker and the type of services that are being provided. It would seem to be poor practice to just pick a part of the test in isolation, which is likely to cause unreliable results.

12. *Q 6 - Control*
 The control element is particularly difficult when used in practice. Again control is dependent on the type of contract and the level of skill and expertise but, it is not always a clear indicator where skilled workers are concerned.

13. It could be said that the less control there is, because the individual is highly skilled, the higher the likelihood that the individual will not substitute their services. This is on the basis that the engager has bought in the individual's skills specifically. This may not, however, indicate that the individual should be paying tax as a deemed employee and, in the employment status case law, under these circumstances other tests would be used to establish the employment status. Most notably, the case law guidance is to stand back and view the whole picture.⁸

14. The OTS agrees that it is a difficult task to design a system that can give an accurate decision on employment status based on case law. One of the problems that has been identified through case law is that the tests will have different weighting depending on whether the labour is skilled or unskilled. The second part of the test that is being proposed does not take this into account and the indicators would be more appropriate for unskilled or lower skilled labour.

15. The question about giving engagers certainty on day one of the hire is a key issue. Even if certainty is given about tax matters, the certainty would only be with regards to the tax status of the individual, not with regards to the employment status of the individual for employment rights. During the OTS's Employment Status Review, one of the key conclusions was that there was "...a universal call for the rules to apply to both tax and employment rights...There would be huge benefits in harmonised rules and the possibilities need to be explored."⁹

⁷ Some tests are more relevant than others when dealing with a "professional man" - *Amalgamated Engineering Union v. Minister of Pensions and National Insurance* [1963] 1 WLR 441.

⁸ *Hall v. Lorimer* [1993] EWCA Civ 25

⁹ Employment Status Review - page 9

16. Feedback received by the OTS stated that the issue for business was certainty in both tax and employment rights. Businesses did not want to be concerned with either a claim for misclassified tax status or a claim through the employment tribunal, so solving one without the other will add considerable uncertainty for business.
17. A joined up approach across tax and employment law, was called for, involving all relevant Government departments. Indeed, the OTS recommended that there be a cross government working group on employment status and this was accepted by the Financial Secretary to the Treasury¹⁰ and has been formed.
18. *Digital Tool*
The OTS carried out an indepth review of the Employment Status Indicator (ESI) tool during the Employment Status Review. The OTS felt that further work was needed with regards to the coding of the ESI and the technical application of the case law that underpinned the tool and recommended that HMRC should review and update the case law, ideally in an open and transparent way, possibly through a working group.
19. The general perception amongst the commentators was that the ESI was biased in favour of HMRC and was not a trusted tool. Any new tool, therefore, is likely to be perceived in the same way unless the coding that is based on the employment status case law is seen to be fair.
20. The OTS also noted in our Employment Status Review that when discussing employment status with their clients, accountants tended to use their own set of questions rather than use the ESI. The conclusion, therefore, is that unless the new digital tool becomes a trusted tool it is unlikely to be used. In which case all parties involved will have to devise their own way of establishing employment status for tax purposes which will be cumbersome and costly.
21. One of the OTS's recommendations, accepted by HMRC, was for a specialist helpline to be established to be available to employers with complex questions about employment status. It is likely that this new tool, however carefully designed, will need similar support, especially while it is bedding down.

¹⁰ At that time, it was David Gauke MP.