

## **Independent Review of Employment Practices in the Modern Economy (Taylor review)**

### **Representation by the Chartered Institute of Taxation**

#### **1 Summary and overview**

- 1.1 While tax (including national insurance) is not formally part of the remit of the review of employment practices in the modern economy, the CIOT believes this area cannot be considered without taking into account the substantial influence of tax differentials in driving choices of employment and business structures. We note the Chancellor's statement in his March 2017 Budget statement that Matthew Taylor had told him that 'differences in tax treatment are a key driver behind the trends we are observing.'
- 1.2 The CIOT considers that there needs to be a wide, open and very public debate on the tax treatment of different kinds of work structures. A key point is whether the tax system should aim for a completely level playing field between employment and self-employment, or whether differentials should be accepted and the focus put on trying to reform and clarify existing distinctions. If significant differentiation is to remain in terms of the tax treatment of different working statuses then we think the tax system should be redesigned so that there are much clearer tax definitions around the borderlines.
- 1.3 The imbalance between the tax burdens on employment and self-employment remains very large, mainly because of the 13.8 per cent cost of employers' national insurance (NIC) and, for the larger employers, 0.5 per cent Apprenticeship Levy which came in in April 2017. This may be the biggest issue to be addressed if the tax system is to keep pace with evolving working practices.
- 1.4 As a starting point in the debate as to how the system could be reformed, one could consider adapting the present narrow scope of employers' NIC (and the Apprenticeship Levy) to broaden it beyond employed workers so that businesses pay a new 'business social contribution' instead. If however we move away from the existing scope of this tax, based on the existence of a legal employment relationship, to try to deal with the issues which it

raises of fairness, economic distortion, and erosion of the tax base, we do need to recognise that there will be difficult issues in defining the expanded scope of a replacement. Consultation is essential if a better result is to be achieved, and public confidence in the new scope of the tax established.

- 1.5 Consideration should also be given to aligning, so far as possible, the income tax regimes for the employed and self-employed, together with a similar alignment of employee Class 1 NICs and Class 4 NICs for the self-employed, and a corresponding move to align, as far as possible, the remaining differences around state welfare benefits. To the extent that complete alignment does not prove possible, the cost of the differential in worker benefits funded by the State and the revenue impact of the differences in rates should broadly match, except to the extent that there is a conscious public policy choice following consultation to favour genuine self-employment to promote the benefits of entrepreneurship and to do so in that specific way.

## 2 Tax impact of changing patterns of working

- 2.1 Broadly there are two significant impacts on the tax base of changing patterns of working from employment toward self-employment (whether substantive, or contrived):

- 2.1.1 Firstly, employment is generally more heavily taxed<sup>1</sup>: by far the main reason for this being that it attracts employers' NIC, so a shift to self-employment will (under the current rates/regimes) generally reduce the tax take; and

- 2.1.2 Secondly, the tax take in respect of employment<sup>2</sup> is received by HMRC through the PAYE system with less need for intervention, and more reliability and regularity, than that from self-employment<sup>3</sup>.

- 2.2 Consequently, any economic trends operating in this direction are reinforced by tax considerations, which impact the tax base. (This is further reinforced if the newly self-employed businesses incorporate.)

- 2.3 Dealing with the second point first, the HMRC 'Making Tax Digital' (MTD) initiative can be seen, in large part, as a strategic attempt to reduce the tax gap and improve the efficiency and predictability of taxation of self-employment. As addressed in the Treasury Committee's recent report on MTD<sup>4</sup>, there is a widespread view that this is the right and possibly only direction to be going in, albeit combined with significant concerns that undue haste,

<sup>1</sup> While this seems a fair generalisation to make, because of the complexities of the national insurance system, there are contrasting cases: for example, once Class 2 is abolished in April 2018, some self-employed individuals with earnings below the lower earnings limit or small profits threshold might need to pay more voluntary contributions than an employed person on similar income would have to pay, in order to obtain equivalent entitlement to those benefits which are in principle available to the employed and self-employed alike.

<sup>2</sup> Including agency workers taxed under PAYE by virtue of section 44, Income Tax (Earnings and Pension) Act 2003.

<sup>3</sup> See [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/561312/HMRC-measuring-tax-gaps-2016.pdf) Table 1.3 on page 18 shows tax gap in cash terms as £7bn from self-assessment yet £2.8bn for PAYE. Page 50 onwards gives more detail.

<sup>4</sup> See <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/making-tax-digital-report-published-16-17/>.

particularly in imposing mandatory requirements in an un-staged way to all but the tiniest businesses, will turn possible long term success into at least short term failure.

- 2.4 As regards the first point that employment is more heavily taxed, this can be demonstrated by the simplified examples<sup>5</sup> in the paragraphs below. In these examples, we have also included the incorporated owner-manager as a distinct category from self-employed. Whilst the self-employed and company owner-managers are often considered as one group, they differ in tax terms quite fundamentally in that the company, as an entity, is taxable in its own right at corporation tax rates with any dividends then being subject to income tax, separately, in the hands of the owner-manager. That said, where an owner-manager works for a customer as if he/she was their employee then IR35 rules apply (as recently modified for those working in the public sector).
- 2.5 Example 1. Income/revenue of £26,364<sup>6</sup> (assuming no expenses, other than the employee cost of the owner manager and assuming no benefits in kind); owner manager pays out a salary equal to personal allowance and all post-tax profit as dividends (assuming that company is not a personal services company within the ambit of the intermediaries' legislation (IR35))<sup>7</sup>.

	Employee	Self-employed	Incorporated owner-manager
Income tax	3,073	3,073	
Employees'/S-employed NI	2,196	1,793	350
Employer's NI	2,520		398
Corporation tax			2,994
Dividend tax			523
<b>Total tax</b>	<b>7,789</b>	<b>4,866</b>	<b>4,265</b>
Of which:			
<b>Paid by individual/company they own</b>	<b>5,269</b>	<b>4,866</b>	<b>4,265</b>
<b>Paid by employing/commissioning body</b>	<b>2,520</b>	<b>0</b>	<b>0</b>

- 2.6 Example 2. Income/revenue of £40,000 (assuming no expenses, other than the employee cost of the owner manager and assuming no benefits in kind)<sup>8</sup>; owner manager pays out a salary equal to personal allowance and all post-tax profit as dividends (assuming that the company is not a personal service company within the ambit of IR35):

<sup>5</sup> There is no perfect way of doing full justice to all the complexities in numerical examples. For example, the tables below do not illustrate the fact that employers' national insurance contributions, along with the underlying salary and employment costs in the case of an employee or the costs of obtaining the equivalent service from either a self-employed sole trader or an entrepreneur's private company, are normally deductible for the employing/engaging business for corporation tax or business income tax purposes.

<sup>6</sup> Office for National Statistics states that the average weekly earnings are £507 per week, or £26,364 per annum.

<sup>7 & 8</sup> The rates and allowances used in both the examples are those applicable for the tax year 2016-17. In addition, we have made a number of simplifying assumptions in order to demonstrate the basic differentials in the tax treatment of each category.

	Employee	Self-employed	Incorporated owner-manager
Income tax	5,800	5,800	
Employees'/S-employed NI	3,831	3,020	349
Employer's NI	4,399		395
Corporation tax			5,721
Dividend tax			1,341
<b>Total tax</b>	<b>14,030</b>	<b>8,820</b>	<b>7,806</b>
Of which:			
<b>Paid by individual/company they own</b>	<b>9,631</b>	<b>8,820</b>	<b>7,806</b>
<b>Paid by employing/commissioning body</b>	<b>4,399</b>	<b>0</b>	<b>0</b>

- 2.7 As the examples show, incorporation obtains additional tax benefits (as well as mitigating risks under PAYE audit for private sector employers/engagers). This incentive to incorporate will be even stronger in 2020/21, assuming the proposed reduction in the corporation tax rate to 17% is implemented. The reduction of the dividend allowance from £5,000 to £2,000 with effect from April 2018, announced in the March 2017 Budget (and which we assume will be re-introduced in a future Finance Bill) will not remove these additional tax benefits. For a basic rate taxpayer, the impact of the dividend allowance reduction cannot exceed £225 pa, a fraction of the typical tax benefits of incorporation at such levels of income. Whereas a reduction in the corporation tax rate would result in the incorporated owner-manager in example 1 benefitting from an increase in net income of £190. Incorporation would, of course, also have enabled a self-employed entrepreneur to fall outside the increases in Class 4 national insurance announced in the March 2017 Budget and later withdrawn.
- 2.8 That there is a difference in the tax treatment, resulting in an incentive toward self-employment/incorporation, is not the only issue with the status quo. There is concern around whether people in, or claiming, self-employment have made a genuine choice to be so (or whether, for example, this is occurring as a result of the organisation/'employer' requiring the work to be undertaken in this way) and while we confine our comments to tax, given our remit and expertise, these concerns strengthen the case for a comprehensive review of the whole area.
- 2.9 The tax issue interacts in a complex way with both people's employment rights vis-à-vis their employer, the rights they may have as a 'worker' regardless of strict employment status, and their social security entitlements. There is a repeated demand by HMRC for anti-avoidance legislation to counter artificial shifts toward self-employment (eg where engagers attempt to mitigate liabilities for employment rights or employer NICs). Thus there is great and increasing compliance cost, complexity and uncertainty around a worker's (including an incorporated owner-manager's) employment status.
- 2.10 Recent cases have further highlighted the complexities and we refer, in particular, to the '*Pimlico Plumbers*' judgment, which highlighted the three possible states for employment law: 'fully' self-employed, 'fully' employed and 'workers' who are not employees but are entitled to a number of rights that employees have. In addition a recent Employment

Tribunal decision *Aslam, Farrar & Others v Uber* found that the Uber drivers were workers and not self-employed, although Uber is appealing this decision.

- 2.11 While the boundary between employment and self-employment is not solely a tax issue, tax can nevertheless be a key driver of behaviour for engagers, workers and intermediaries. We therefore consider that addressing the differentials in tax treatment and, in particular, the taxes paid under the different types of engagement has to be a key part to modernising employment practices.

### **3 Possible approaches to addressing the issue of tax differentials**

- 3.1 One solution advanced to simplify the current position is to 'level the playing field'; that is to impose so far as possible the same effective tax burden on employment and self-employment. However, 'levelling the playing field' between employment and self-employment would not be without its difficulties.
- 3.2 Firstly, such a change would likely result in a larger tax burden falling on the self-employed. Being less numerous than the employed population (the majority, over 80%, of the UK's workforce is still made up of employees), the individual losses suffered by the self-employed would likely exceed any individual gains there might be to others, even if change was effected in a revenue-neutral way. Many self-employed people have low incomes and discussion about their tax and national insurance obligations inevitably throws into focus the impact on work incentives of the Minimum Income Floor in Universal Credit highlighted recently by LITRG<sup>9</sup>.
- 3.3 Secondly, it can be argued that there may be sound policy reasons for 'discriminating' in favour of the self-employed. 'Levelling the playing field' might mean that there would be no recognition in the tax system (in terms of equity) of the additional risks to which those who choose the path of self-employment might be exposed, and (in terms of economic benefit) the positive 'externalities' which entrepreneurialism brings to the economy, benefiting the wider population. That said, being self-employed is not synonymous with being entrepreneurial, and there is a case for saying that it is entrepreneurialism rather than the legal status of self-employment that should be encouraged. Furthermore, there are arguments that it should be left to the market place to 'reward' the self-employed through higher pay rates; and that in many cases, self-employed workers are not entrepreneurs and suffer very little in the way of additional financial risks compared with some employees (especially those employees on short, fixed-term contracts or indeed those who are truly in law employees but are economically coerced into claiming self-employment status).
- 3.4 There would no doubt be extensive debate and disagreement across different individuals and sections of society about whether, and if so, to what extent, the tax system should give weight to discriminating in favour of the self-employed, and how the design of the tax system should most sensibly be adapted to reflect this whilst minimising tax incentives to artificially move workers from one type of working practice to another.
- 3.5 It should be noted that a range of reliefs have been introduced into the tax system over recent decades under different governments to reflect factors of the above sort – including such diverse mechanisms as business expansion scheme, profit-related pay, enterprise

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<sup>9</sup> To read the most recent comments of LITRG go to: <http://www.litr.org.uk/sites/default/files/files/170116-LITRG-response-WPC-self-employment-FINAL.pdf>

investment scheme, capital gains business asset taper relief, and entrepreneurs' relief. This testifies both to widely shared recognition of the value of encouraging entrepreneurialism and (since some of these have been discarded and all have been regularly chopped and changed) the difficulty of efficient and effective design.

- 3.6 We would however add that almost all of the provisions intended to encourage entrepreneurialism referred to in the previous paragraph have been introduced, modified or abandoned by Chancellors on Budget Day (or the day of the Autumn Statement, or some similar fiscal event), with little or no prior consultation but with considerable design detail already 'set in stone'. Thus this is just one area where, as suggested in the report 'Better Budgets' which we co-authored with the Institute for Fiscal Studies and Institute for Government, there is a better way of proceeding. Chapter 4 of our report<sup>10</sup> sets out 10 steps which would help to achieve better budgets and tax policy making. However, the chapter starts by setting out a simple vision of: *'A Budget process that contains fewer measures that are better thought out – and can be implemented efficiently by HMRC without imposing unreasonable burdens on taxpayers.'* We believe that this can be achieved by *'[A] better public debate on the big tax choices – with politicians making informed decisions.'* The aim being *'Greater stability in the areas of the tax system where taxpayers – individuals and business – need to make long-run decisions. A tax system that commands public support – and is robust enough to raise the money we need to finance the state we want.'*
- 3.7 If it is concluded that entrepreneurialism is to be encouraged or rewarded in some way via the tax system, it would become necessary to distinguish between genuine entrepreneurialism and the kind of self-employment (whether undertaken through a company or not) which has been entered into simply to minimise taxation or because an 'employer' wishes to avoid liability to workplace benefits (and a liability to employers' NIC). (It would also be important that the proposed quantum of any such differentiation should be stated and justified and that the differentiation should be periodically reviewed, as good tax policy procedures would suggest.)
- 3.8 One option to be considered for distinguishing genuine entrepreneurialism would be to adopt some form of statutory employment (versus self-employment) test for tax purposes along similar lines to the statutory residence test, introduced in April 2013. UK residence (versus non-residence) is, like employment versus self-employment, a fundamental building block of the tax system – yet in recent decades there had been regular disputes and litigation about it with the case law yielding many 'rules of thumb' but few hard-and-fast rules tending toward certainty or reliability. The introduction of the statutory residence test was carried through in a consultative manner over a long period, and, most significantly, the Government was prepared to delay implementation to allow it to be got right. The result is undoubtedly, still, highly complex, but does at least provide something like a clear 'decision tree' which can provide an answer with less need of such recurrent and costly litigation. In the case of the employment/self-employment distinction as it should be applied for tax purposes, such factors as whether labour is typically provided to a single (or very low number of) engagers over a particular period, or whether the individual provides the bulk of any tools or equipment needed, might be key elements of a more tightly defined test.
- 3.9 However, this would not be the inevitable outcome of such a consultative process. If a key 'externality' potentially justifying favourable treatment for self-employment is that it leads to further job creation, another option to explore is the extent to which taxes should be

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[http://www.tax.org.uk/system/files\\_force/file\\_uploads/CIOT%20IFS%20ifG%20tax%20report%20WEB.pdf?download=1](http://www.tax.org.uk/system/files_force/file_uploads/CIOT%20IFS%20ifG%20tax%20report%20WEB.pdf?download=1)

reduced for firms hiring their first employees, and whether this should be as well as, or instead of, favourable treatment for the self-employed individuals themselves?

- 3.10 If the 'level playing field' approach were favoured following the consultation process, the key issue to be addressed is employers' national insurance contributions. (Indeed this might need to be addressed in any event, given the very large scale and relative significance of this particular tax cost.) It is clearly not realistic for this to be abolished. Consideration should therefore be given to reforming and recalibrating it in the form of a 'business social contribution' levied on a broader base. If however we move away from the existing scope of this tax, based on the existence of a legal employment relationship, to try to deal with the issues which it raises of fairness, economic distortion, and erosion of the tax base, we do need to recognise that there will be difficult issues in defining the expanded scope of any reformed levy. Consultation is essential if a better result is to be achieved and public confidence in the new scope of the tax established.
- 3.11 As regards tax and national insurance costs imposed on the individual, whilst the tax system has imposed 'deemed employment status' on agency workers, incorporated-owner managers within the remit of IR35 and now off-payroll workers in the public sector, the fundamental issue to be addressed is whether there should be a tax differential between the (genuinely) self-employed worker and the worker who is employed and if so, what its shape and amount should be. In principle, insofar as self-employed workers and the employed workers are similarly supported by the State in regard to welfare benefits, then the starting point for discussion should be that they should contribute equally. In which case there should be a move to equating the Class 1 employee and Class 4 (self-employed) national insurance contributions in a revenue-neutral way. However, to the extent that complete alignment of such benefits does not prove possible, the fall back position would be that the cost of the differential in benefits and the revenue impact of the differences in NIC rates payable by the employed and the self-employed should broadly match. In principle, one might depart from this position of balance, if there is widespread support for the ideas of encouraging and rewarding entrepreneurialism through the tax system, and of doing so in this way. However, it is not clear in today's 'gig economy', how easy it is to identify entrepreneurialism based on a legal definition, and it is important that any particular differentiation introduced should be properly justified both as to its shape and amount and should be subject to periodic review.
- 3.12 There are further issues that would need to be considered in consultation. Even if some tax distinctions are retained between employment and self-employment, but the distinction is reformed and clarified (as we think it should be, if it is retained), then some people with a legal status of self-employment are in effect likely to be 'deemed' to be employed for tax purposes. This raises issues around extending PAYE withholding obligations, and as to whether these should be capable of being avoided by the workers concerned incorporating their 'businesses'. Successive governments attempts to address apparent avoidance (of tax or employment rights obligations) through the intra-positioning of personal service companies (PSCs) between an engager or intermediary and the worker have resulted in legislation commonly known as the IR35 rules and, now, new IR35 rules for off-payroll workers in the public sector. If the new (Chapter 10) IR35 rules for workers in the public sector can be shown to be practical in their day-to-day operation by public sector bodies, employment intermediaries, workers and HMRC, then the issue will arise as to whether they should be extended to apply to the private sector too. The differences between the pre-existing IR35 rules and the new public sector rules (despite only being introduced on 6 April 2017) are already causing distortions in the market as, for example, we hear anecdotally of media workers, doctors and IT professionals quitting the public sector (including the NHS

and HMRC) to go and work in the private sector. However, new definitions would be required to determine when such withholding would be required despite the existence of a corporate intermediary. This would not be straightforward and would require consultation to achieve an effective and acceptable design. If, on the other hand, there is not a consultative approach to the fundamental issues raised in this submission, the risk is that a succession of piecemeal changes, driven by anti-avoidance concerns, will bring new complexities and anomalies and less public understanding and acceptance.

#### **4 The Chartered Institute of Taxation**

- 4.1 The Chartered Institute of Taxation (CIOT) is the leading professional body in the United Kingdom concerned solely with taxation. The CIOT is an educational charity, promoting education and study of the administration and practice of taxation. One of our key aims is to work for a better, more efficient, tax system for all affected by it – taxpayers, their advisers and the authorities. The CIOT's work covers all aspects of taxation, including direct and indirect taxes and duties. Through our Low Incomes Tax Reform Group (LITRG), the CIOT has a particular focus on improving the tax system, including tax credits and benefits, for the unrepresented taxpayer.

The CIOT draws on our members' experience in private practice, commerce and industry, government and academia to improve tax administration and propose and explain how tax policy objectives can most effectively be achieved. We also link to, and draw on, similar leading professional tax bodies in other countries. The CIOT's comments and recommendations on tax issues are made in line with our charitable objectives: we are politically neutral in our work.

The CIOT's 18,000 members have the practising title of 'Chartered Tax Adviser' and the designatory letters 'CTA', to represent the leading tax qualification.

The Chartered Institute of Taxation  
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