Time for change

Employment Tax | Large Corporate

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Bill Dodwell asks whether personal service companies have had their day

In 1999, Chancellor Gordon Brown announced that measures would be introduced to counter tax avoidance by the use of so-called ‘personal service companies’. The measures are commonly referred to by the relevant Inland Revenue budget press release in which they were announced, titled IR35: Countering Avoidance in the Provision of Personal Services. The press release noted ‘The aim of the proposed changes is to ensure that people working in what is in effect disguised employment will, in practice, pay the same tax and national insurance as someone employed directly.’

Interestingly, the history of potential challenge to the use of service companies goes much further back. The IR35 legislation was the subject of judicial review, on claims by the Professional Contractors Group that it infringed the human rights and EU freedoms of the contractors. Mr Justice Burton had no difficulty in dismissing both challenges, but his 2001 judgment notes that the Conservative government of 1981 had considered legislation to 'ensure that temporary agency workers who work under conditions which are typical of employment rather than self-employment are, like employees, taxed under Schedule E and subject to PAYE' whether or not they operated 'through a company'. After debate, the government announced it would not go ahead with the proposal.

Seventeen years later, Gordon Brown revisited the issue. The initial proposal was for the engager to test whether the relationship was one of employment or self-employment. The revised version passed on that responsibility to the personal service company. The IR35 press release said that up to 66,000 companies were the target. The new intermediaries' legislation came into force in April 2000 and is now in ITEPA (the Income Tax (Earnings and Pensions) Act 2003) and in the Social Security Contributions (Intermediaries) Regulations 2000, SI 2000/727.

Helen Miller from the Institute for Fiscal Studies has pointed out how the use of a personal service company saves tax for its owner. Typically companies pay low amounts to the owner/manager (sometimes as low as the national insurance lower amount – about £8,000pa). Expenses are naturally borne in the company and the balance taxed at the small profits rate. This has been 20% or less for many years. The balance is then paid on to the owner as a dividend. Further savings can be made in some cases. Companies often end up being owned by the worker and other members of his or her household, thus potentially accessing more than one personal allowance and basic rate band. The Arctic Systems case illustrated this. It can also be possible to retain earnings in the company to be paid out in a future year, or accessed on liquidation when potentially capital gains tax, including entrepreneur's relief, could be payable.

In an attempt to reduce the tax advantages of using a personal service company, in 2016 the government changed the way dividends are taxed. The long-standing dividend tax credit was abolished and dividends taxed at special rates from 7.5% to 38.1%. A £5,000 dividend allowance was introduced. The impact on someone taking £40,000 from such a company was additional tax of about £1,000 – but still less than a self-employed individual.

A second change took effect in April 2017, when public sector engagers of workers (and agency providers) took responsibility for assessing whether the worker is a quasi-employee. HMRC has released an imperfect online employment assessment tool to help work out whether the engagement is quasi-employment. For more on IR35, see *Patrolling the waters*.

The problem with these changes is that we seem to be tinkering with the issue. Pushing up dividend taxation doesn't replicate national insurance, even before income splitting. Calculations by the IFS suggest that the difference between the taxation of the employed and the self-employed/engaged through companies is about £16 billion. It doesn't seem a practical possibility to equalise taxation – but it would be good to take some steps in that direction. Unless we do, the gradual shift away from the employed model will continue to be fuelled by tax differences.

Three changes would be sensible steps:

Firstly, the 2017 changes on responsibility for assessing status need to be extended from the public sector to the private sector. It is well-known that many personal service companies do not apply the employment/self-employment test accurately. Without passing on responsibility to the engager, a difference between public and private sector will grow – for no good reason at all.

Secondly, its surely time to introduce a statutory test for employment/self-employment. Businesses and individuals need greater clarity than the old case law provides. A simple test wouldn't work, though. Instead, the model should surely be the statutory residence test, which contains a number of factors to be assessed before determining the answer. The multi-factor matrix put forward by IPSE (the former Professional Contractors Group) to the Taylor Review is the type of thing that would help.

Finally, don’t we need to provide that the individual service provider should be directly taxed, irrespective of whether a personal service company is involved? Australia has this sort of model. No doubt naysayers will point out little flaws – but they’re blinded by the huge gaping hole in the system, which lets individuals provide services through companies and cut their tax bill.