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Tax Law Review Committee

# Tax and employment status: myths that are endangering sensible tax reform



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## Summary

The Tax Law Review Committee (TLRC) and the Institute for Fiscal Studies have made many contributions to the debate on tax and employment status. The TLRC first reported on the topic in 2001. This was developed in work done for the Mirrlees Review. More recently, the IFS 2017 Green Budget report returned to the subject and work is continuing in this area.<sup>1</sup> We do not rehearse all the arguments in these papers in this note but aim to address some specific myths which we believe need to be dispelled.

The recent report of the House of Lords Finance Bill Sub Committee on Off-Payroll working (HL FB report) has once again raised the need for the Government to tackle the problem of employment status in both the employment law and tax contexts.<sup>2</sup>

The HL FB report suggests that the off-payroll rules build on a flawed system - IR35. In fact, it is the underlying system that is flawed. IR35 was merely designed to plaster over cracks in the wall. If the cracks continue to appear, as they have done, that should tell us that the problem lies elsewhere, in the foundations.

- The TLRC strongly supports the recommendation of the HL FB Report that a fundamental review is needed.
- We share the view of the Taylor Review that the UK's tax system should develop 'a more consistent level of taxation on different forms of labour'<sup>3</sup>
- We do not agree with Taylor or the Government's response to Taylor<sup>4</sup> that a single statutory definition of employment status for all purposes will improve

<sup>1</sup> Full references to these papers are listed below.

<sup>2</sup> House of Lords Economic Affairs Committee Finance Bill Sub-Committee *Off-payroll working: treating people fairly* 1<sup>st</sup> Report of Session 2019-20, HL Paper 50 (HL:2020)

<sup>3</sup> M. Taylor, *Good Work: The Taylor Review of modern working practices* (July 2017) BEIS.

<sup>4</sup> *Good Work Plan* (2018) BEIS.

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the current situation. If anything, it will increase distortions and the problems of the definitional cliff edge.

This paper addresses some misperceptions – myths – that have built up and taken hold of the debate around the current tax structure and its relationship with employment law. Once these are understood to be myths, the way forward should be clearer.

Here we summarise our points, which we then support with analysis in the next section.

- Employment law and tax law have different policy objectives. The design for each of these areas of law should not be constrained by reference to the needs of the other area.
- Differences in State benefits entitlement between the employed and self-employed do not account for the differences in tax rates.
- The fact that the self-employed have fewer employment rights than employees does not mean they should pay lower rates of tax. The relationship between those providing labour or services and those using those services should be regulated by contract and statute. On the whole it is best not to distort commercial arrangements by tax considerations. Even if it is desired to encourage or support certain working arrangements, a blanket tax relief for all ‘self-employed’ (which is bound to be a heterogeneous group, however defined) is not a well targeted or effective way to achieve this.
- There is no therefore no principle that requires treatment of different groups for tax purposes to be linked to their treatment for employment law purposes.
- It may sound simpler to have one definition for all purposes but the attempt to create a definition suitable for two or more very different policy objectives is likely to complicate both areas and result in a definition that is appropriate for neither area.

Therefore, we argue that the only way to fix the problems created by a poorly designed tax system is to fix the tax system. Tax considerations should not distort employment law or inhibit any reforms to employment law. Similarly, employment law or changes to employment law should not distort taxation decisions or inhibit tax reforms.

## Background

There is a major problem at the heart of the UK tax system: the incomes people earn are taxed very differently according to legal form. Individuals working free-lance as sole traders or partners are taxed at significantly lower rates than they would be if they worked as employees. Individuals who choose to operate through their own personal services company gain an even greater tax advantage.

In other words, there is a major tax penalty on employment. This is not a new problem, but it is one that has grown over the years due to changes in working practices and the structure of the tax system. There is, in particular, a tax incentive to operate through a personal services company. The use of personal services companies has been addressed somewhat unsuccessfully by an anti-avoidance measure (IR35). This approach was doomed to fail and is failing because it moves some people from one side of the line to the other on the basis of the application of case law that has evolved over the years in the context of many areas of law and is not designed to address this specific tax issue. The case law is very fact based and has become hard to apply. The Off-payroll legislation simply builds on this and puts the onus of applying this uncertain law on the engager rather than the engaged taxpayer. This cannot solve the underlying problems.

The real solution is not to change where the line is drawn but to try to ensure that all workers pay similar amounts of tax, so that it is irrelevant on which side of the line they fall for tax purposes. That is, the aim should be, as far as possible, to align the tax treatment of all who supply their labour, irrespective of the legal basis on which they do so.

If this cannot be achieved in the short term, there might be an argument for a statutory definition of who is treated in which way for tax purposes, but this need not be related to employment law. Rather it should be based on the extent to which it is convenient and valuable to apply PAYE or some other form of deduction at source. This can only be a second-best approach.

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There is a growing swell of opinion that the time has come to make real changes towards greater alignment of tax treatment across different types of work status. The current crisis has opened an opportunity to do so. When announcing the SEISS, the Chancellor said:

*“in devising this scheme – in response to many calls for support – it is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future”.<sup>5</sup>*

We do not suggest that it will be easy to achieve a consensus on the necessary measures. There is a real danger, however, that three persistent myths will hamper reform. If not properly understood, they may leave us with a system that continues to create distortions, complexity and unfairness, and may even make the system worse.

<sup>5</sup> 26th March 2020.



## The Myths

### Myth 1: Lower rates of tax for the self-employed are justified by reduced access to government benefits

There are substantially lower taxes for business owner managers than employees.<sup>6</sup> However, it is a myth to believe that this difference is explained by the differences in benefits entitlements- it is not.

Much of the difference in the amount paid arises as a result of National Insurance Contributions (NICs).<sup>7</sup>

- The combined rate of employee NICs (12%) and employer NICs (13.8%) is 22.7%.<sup>8</sup>
- The rate of self-employed (Class 4) NICs is 9%. The self-employed also face class 2 NICs at £3.05 per week.
- The self-employed pay £5.6 billion less in National Insurance than if they were subject to the same overall (including employer) NICs as employees.<sup>9</sup> This difference is not accounted for by differences in state benefits, as explained below.
- Company owner managers can access lower tax rates than employees by paying themselves low wages and then taking money out of the company as dividends or capital gains, both of which are taxed at lower rates than labour income

<sup>6</sup> For example, a job that generates £40,000 of income in a year (i.e. that is the total amount that someone pays to have the job done) will attract tax of around £11,700 if carried out by an employee but around £8,400 (over £3,300 less) if the person is self-employed.

<sup>7</sup> For a discussion of the various other tax benefits available to business owner-managers see Adam et al (2017).

<sup>8</sup> The combined additional rate (applied to income over £50,000) is 13.9%. The comparable rate for the self-employed is 2%.

<sup>9</sup> HMRC, 'Estimated cost of Structural Tax Reliefs', October 2019, available at: [gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs](https://www.gov.uk/government/statistics/minor-tax-expenditures-and-structural-reliefs).

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(even after taking account of corporation tax paid; in the case of dividends largely due to NICs not being payable).

There are very small differences in government benefits provided to different groups in normal times.

- There are just two publicly funded ‘contributory’ benefits that employees can access that the self-employed cannot: contribution-based jobseeker’s allowance (JSA) and statutory parental pay. The overall cost of these to the State is much smaller than the cost of the lower NICs payments from the self-employed tax breaks. This cost difference could be used to justify less than a 1 percentage point difference in the overall tax rates (i.e. a rate for the self-employed that was no more than 1 percentage point below 22.7%). In addition, in both cases there are alternatives that the self-employed can access. For example, the self-employed cannot access contribution-based JSA (which is around £74 a week for 6 months), but they can access income based JSA in limited circumstances or means tested Universal Credit if their savings and earnings are below a certain level. The amounts vary depending on circumstances.
- The most significant disadvantage faced by the self-employed in the benefits system comes from the minimum income floor within Universal Credit. This treats the self-employed as earning at least a certain amount, even if they report lower earnings, and gives them correspondingly less support.<sup>10</sup>
- During the pandemic the government tried to give employees and the self-employed broadly comparable support. Some of the differences in treatment result from the administrative difficulties of operating equivalent programmes for different groups. The Self-Employed Income Support Scheme (SEISS), which provided grants to the self-employed whose profits were reduced by the COVID-19 crisis, was designed to provide government support that was comparable to that provided to employees through the Coronavirus Job Retention Scheme (CJRS). There were people who fell through the gaps of both schemes. Some of the gaps in both schemes result from absence of records upon which to base payments. So people who were just starting out in business lost

<sup>10</sup> This is designed to prevent the benefits system from subsidizing those who earn below minimum wage, perhaps because they have non-commercial businesses, but it can penalize those who genuinely cannot find business.

out. One group who were not paid as much as they felt they were entitled to were company owner-managers who were mostly eligible to use the CJRS as employees but who paid themselves mainly in dividends not salary. However, there are also self-employed people whose total income was higher than it would otherwise have been as a result of the SEISS; in some ways the SEISS was more generous than the CJRS since the self-employed could claim and continue to run their business.<sup>11</sup>

- The minimum income floor in UC has been suspended for the duration of the outbreak. ‘Conditionality’ for employees accessing UC was also suspended at the start of the crisis but has now been reinstated.
- One difference in treatment is in relation to Statutory Sick Pay (SSP). For some years SSP has been covered by employers; during the Covid pandemic the government has made some reimbursements of SSP where employees are eligible for sick pay due to coronavirus.

The fact that the government has tried to offer comparable insurance to different groups during the crisis bolsters the case that different groups should be taxed in (at least more) comparable ways as the economy recovers. Where there have been differences this will raise issues about differences in contributions but the differences have not pointed all in one direction. It will be better to consider these differences in the context of removing them for the future.

Many company directors who have felt excluded from the Government schemes set up to help with the pandemic have been vocal about the fact that they consider their dividends to be salary, making it harder for them to argue that it should not be taxed as such in the future.

<sup>11</sup> For a full comparison see Adam et al 2020.

## Myth 2: Fairness requires the self-employed to get lower tax rates because they do not have employment rights

A common misconception is that the self-employed should benefit from lower taxes because they do not benefit from employment rights under employment law. Put conversely, the argument would be that those who do benefit from employment rights should pay more tax. This is commonly held up as a problem with IR35 – it changes tax payments but not employment rights such as holiday pay or membership of the workplace pension scheme.

The line of reasoning behind this myth is the basis for calls (as in the Taylor Review) to align more closely definitions in tax and employment law. While this may sound compelling, the ‘logic’ behind this line of argument is flawed.

It is important to note that any costs of providing employment rights are borne by the employer and not by the State. So requiring higher NICs for employees and employers does not result in these employment rights being funded through the extra tax paid - on the contrary the cost of employment increases yet further. (This is the key difference relative to the government funded benefits discussed above.)

Consider the perspective of an employer. The legal requirement to provide employment rights represents a cost.<sup>12</sup> This cost, all else being equal, makes contracting with a self-employed person more attractive than hiring an employee. That is, employment rights skew the labour market in favour of the self-employed legal form. The tax system – which requires employers to pay 13.8% employer NICs when using employees – further skews the labour market against employment.

<sup>12</sup> The cost need not take the form of an ongoing financial outlay or even of an explicit cost that is deductible for tax purposes. It could, for example, reflect the expectation that, in some states of the world (such as when an economic crisis occurs), an employer will need to provide wages to employees at a point where they are less productive than normal (i.e. provide some job security).

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The tax system is reinforcing, not offsetting, the bias created by employment rights. There will be people who would have been offered employment contracts and the associated rights had it not been for the distortion added by the tax system. If we were trying to use the tax system to offset the distortions created by employment rights, it would call for LOWER, not higher, taxes on employment than on self-employment.

If instead we consider the perspective of employees and the self-employed, it can also be seen that lower taxes are not acting as a substitute or compensation for employment rights.

In some cases, remuneration will adjust to fully offset the effects of employment rights. That is, an employee's wage will fall to reflect the value of the benefits they are receiving and the self-employed will be able to negotiate for higher income (relative to the employee) as compensation for the lack of employment rights. In such a case, there is clearly nothing for the tax system to try to offset.

Decreasing tax on the self-employed is simply providing that group with an advantage that the employed do not have. However, there will be other cases where employment rights (or the lack thereof) are not reflected in remuneration; for example, where the self-employed have little bargaining power.

However, regardless of how remuneration adjusts, lower taxes for the self-employed are not acting as an offset for a lack of employment rights. One issue is that the lower rates would only provide compensation on average (i.e. lower taxes for the self-employed would overcompensate those who have managed to secure higher wages).

A more important and general point is that, in economic terms, employment rights are a transfer from employers to employees. Using taxes to replicate this effect would require that any benefit given to the self-employed through lower taxes is exactly balanced by higher costs through higher taxes on their engagers.<sup>13</sup> Without

<sup>13</sup> In this context, a self-employed person can often be thought of both as the person doing the work (i.e. the equivalent of an employee) and the person running the business (i.e. the equivalent of an employer). Replicating employment rights through tax in this case can be seen to make no sense because it requires simultaneously higher and lower taxes on the self-employed person.

the latter, engagers would be benefiting from having no employment costs and not paying higher fees to compensate for that.

This is why the current tax system provides a bias in favour of work that is done through self-employment relative to employment. This is not to deny that the self-employed receive a benefit from lower taxes – they clearly do. But that tax benefit is not and can never be the equivalent of employment rights. As highlighted above, providing that benefit means that fewer employment opportunities will be made available, to the detriment of those self-employed people who would prefer to be employees.

Where there are concerns that the self-employed lack bargaining power or would benefit from protections, this is something that needs to be dealt with through labour law and regulations not taxation.

### **Myth 3: The employment law definition of employment status should provide the framework for tax treatment.**

If it is accepted that the current lower rates of tax given to the self-employed are not justified by differences in State benefits or employer provided employment rights, as we have argued above, then it follows that it is a misconception that the tax system needs to use the employment law definition of employment status to determine tax treatment. There is no principled reason why the dividing line should sit in the same place for two completely different sets of policy issues with different objectives. Employment law sets out to regulate employment relationships and protect those supplying their labour and tax law needs to collect revenue efficiently and equitably.

Ideally, we think there should be no difference in tax rates across different legal forms. There will need to be different methods of tax assessment and collection to recognise different circumstances – a business with employees, stock and premises will need different arrangements from a service provider working alone – but the different methods of tax assessment do not need to be tied to the employment law definition of employment and can be designed based on whether collection at source will work well and how and when data can best be provided to the revenue

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authority. This needs to be reviewed in any event for the digital age and new approaches should not be constrained by the limitations of employment law, not should they impact on labour law. There is no reason why the answer to who should have certain types of labour market protection should be the same as the answers to how we should administer taxes.

There are some who would support lower taxes on some types of business owners as a way to promote entrepreneurship. Across the board lower taxes on all of the self-employed is an extremely poorly targeted and costly way to do this. If the government would like to pursue lower taxes for a subset of business owners, there is no reason why this should be linked in any way to the definition of employment within employment law.

Employment status is an important concept in many areas of law, including employment law, tort, immigration law, health and safety and tax. Each of these areas of law serves different objectives and so may need differences in definition. By using a common definition of employment, policy makers would be constraining their policy options. Trying to create a one-size fits all test may make the test second best for both purposes.

There are already statutory differences between the definition of employment status in different areas of law. Although the case law on employment status is said to be the same for each area, differences emerge from the very fact-based cases. There is no longer an assumption that a person who is an employee for one purpose will be so for all (as pointed out by Lady Hale in *Barclays Bank plc v Various Claimants*, a case on vicarious liability).<sup>14</sup>

One reason IR35 has been so unsuccessful and created such uncertainty is that it depends on case law that has evolved for wider and different purposes. Extensive litigation in an IR35 context on some factors may even result in further uncertainty and pressure on the employment relationship cases in other contexts. The linkage of tax law to employment status distorts employment law relationships in an undesirable way and, although it sounds simple, this perception of simplicity is

<sup>14</sup> [2020] UKSC 13, para 29.

misleading, since it would require a complex and ultimately imperfect test. Rather than attempting an alignment of frameworks that is bound to lead to problems, we should design each framework to meet its own objectives.

# How to fix the system

There is a widely recognised need for radical reform in this area. Potential reforms are considered in more detail in the papers referred to below.

It is argued here that -

- The lower rates of tax for the self-employed cannot be justified by the small differences in access to government benefits
- Fairness does not require the self-employed to get lower tax rates because they do not have employment rights
- The aim should be to bring levels of taxation and the tax base closer together for all those who supply labour, regardless of the legal form in which they do this.
- Employment status is an important concept in many areas of law. Each of these areas of law serves different objectives and so may need differences in definition.



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