

Horizontal Equity and the Taxation of Employed and Self-Employed Workers

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Abstract

The schedular system of income tax in the UK frequently comes under attack, not least in relation to the distinctions it draws between the tax treatment of the employed and the self-employed. However, on examination, it appears that non-schedular systems of taxation share both these distinctions and the difficulties that arise from them, albeit to varying degrees. The division between employed and self-employed is also problematic for social security systems. These difficulties are found, to a greater or lesser extent, in all the jurisdictions studied by the authors. It may be argued that all or some of the tax and social security differences are justified by fundamental economic and legal differences between the nature of employment and self-employment relationships. This may be true where the relationships compared are unambiguously, on the one hand, employment and, on the other, self-employment. However, there have always been non-standard relationships that combine characteristics of both these broad categories. This grey area appears to be increasing with changing work patterns. Consequently, the simple dichotomous system adopted by the UK tax and social security systems has come under pressure. This article considers the problems arising from this situation and some of the ideas that have been put forward to deal with them.

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I. INTRODUCTION

In its report *Reforming the Personal Tax System* (Institute for Fiscal Studies, 1993), an IFS committee commented:

In any reform, it might be sensible to think about reducing the distinction in tax treatment between employment and self-employment, on simple equity grounds as much as for any other reason. Why should individuals carrying on essentially the same activity and deriving similar income from it, exhibit large differences in liability to income tax just because one does so as a self-employed person while the other is employed?

Although it makes some assumptions that are questionable and that will require further examination later in this article, this comment seems to reflect a widespread perception about the relative tax treatment of the employed and self-employed. This is a long-standing background issue: a grumbling, rather than an acute, one, but it is of potential concern to a wide range of taxpayers. Therefore it is not surprising that the Tax Law Review Committee (TLRC) should decide to examine the topic, a project upon which the authors of this article are currently engaged on the Committee's behalf. However, the Committee has not yet decided whether any recommendations should be made, far less what recommendations might be desirable. Thus, whilst what follows has been informed by discussions with the Committee, it does not represent the views of the Committee in any way. The objective of this article is to set out the issues and problems in a structured way with a view to stimulating a focused debate in an area dogged with assumptions and confusions and in which the strict law and practice can differ considerably. Various possible changes to the current system will be considered. The overriding questions for debate must be whether the current system is so inequitable between taxpayers that reform is desirable and, even if that is so, whether an alternative system can be found that has fewer associated problems than the present one.

II. THE ISSUES

The issue of classification of workers as employed or self-employed and that of the differences in the tax and social security rules governing the two categories are distinct in some respects and yet interlinked. Some suggest that the starting-point for reform should be the differences in the rules: if these could be aligned or brought closer together, the classification issue would automatically become less significant and therefore less problematic. For others, there is clearly a fundamental difference in terms of economic reality as between the 'genuinely' self-employed and 'true' employees which leads to the practical necessity for

different rules, particularly in respect of administration and collection, but also in terms of substantive rules.

This latter group would argue that, by definition, employees and the self-employed are not individuals carrying on essentially the same activity and therefore there is no breach of horizontal equity involved in treating them differently. If that is the case, although the rules might be brought closer together, they will never be sufficiently close to avoid the need for distinct classifications and there is no need for alignment of rules, although the method of classification might need modification to ensure that it suits current economic conditions.

Therefore these two interconnected issues of worker classification and applicable rules must be examined side by side. The extent to which the classifications can be manipulated and the outcome of any given case predicted must be examined. Differences in treatment between the different groups must be justified on the basis of the requirements of the relationship in question, practicality and efficiency in collecting revenue, and these factors must, as always, be balanced against those of equity and reduction in burden for businesses and individual taxpayers.

One further point should be noted before proceeding with a discussion of the issues. If the basic question to be addressed is lack of equity as between two groups of taxpayers, it follows that any reforms will have distributional consequences. If the changes are to be revenue-neutral, there will be losers. Our starting-point is that differential treatment between groups of taxpayers should be the result of deliberate policy, carefully costed and targeted so as to achieve the desired incentive effect rather than an undesired distortion (Kay and King, 1990). In the end, the extent of any differences must be a policy decision for Ministers, but those Ministers must be advised of *all* the implications of their decision.

III. DIFFERENCES IN TREATMENT

There are four main areas of difference in tax and National Insurance treatment of the employed and self-employed:

- collection mechanisms and timing;
- the income tax base;
- National Insurance contributions and benefits;
- VAT.

There are, of course, also a number of non-tax differences of great importance, in particular the application of employment law to employees and commercial considerations. On the whole, the tax differences tend to reinforce the employment law considerations in reducing costs for those businesses that use self-employed contractors rather than employees. However, commercial considerations might pull in the other direction, since businesses want to build up a well-trained and

loyal work-force. For individual workers, there may be financial benefits in being self-employed that outweigh the loss of job security and National Insurance benefits, although there are some others, often at the lower end of the pay scale, who suffer from not being treated as employees (Harvey, 1995; Stanworth, 1996). It is, of course, the case that self-employed individuals enjoy greater opportunities for evasion than employed taxpayers and some will operate entirely within the 'black economy' (Soos, 1990).

There are currently 18.9 million taxpayers whose principal source of income comes from employment, compared with only 3.3 million with income from self-employment (Government Statistical Service, 1996). These numbers have their own impact on the development of both administrative systems and substantive rules, since certain refinements and complexities that can be dealt with in the case of the self-employed are much more difficult to apply to employees, for reasons of cost and practicality.

1. Collection Mechanism and Timing

The appropriate method of collecting tax is directly linked to method of remuneration. At one extreme, periodic payments from one payer, net of any expenses, can easily and effectively be taxed at source without adjustment, eliminating the need for contact between the recipient worker and the Revenue authorities in many cases. At the other end of the spectrum, where there is a business organisation with a number of customers and clients (payers) and expenses in terms of goods and materials provided to those payers or used in order to provide them with services, it will be necessary for accounts to be made up for a period. Only at the end of that period can any assessment be made of the profit produced.

In the UK, employees pay tax under Schedule E on the emoluments from their employment. Most benefits in kind and cash fringe benefits are within the tax net, so that, despite the existence of some difficult cases and a certain amount of complexity in the legislation, the amount to be taxed can normally be calculated as soon as it is paid. The cumulative pay-as-you-earn (PAYE) system is designed to collect the correct amount of tax on employment income on a regular, current-year basis so that the vast majority of employees do not need to fill in a tax return.

Although all systems we have studied impose a withholding tax on employment income as shown in Table 1, some non-UK systems use a non-cumulative system for employees which does not avoid a year-end reckoning and may well result in an over-deduction. Over-deduction can cause hardship and higher administrative costs but provides an incentive for rapid submission of tax returns at the year-end so that a repayment can be claimed. The UK's cumulative PAYE, by contrast, reduces the work of the Revenue authorities and the individual taxpayer but imposes a burden on employers. The burden of PAYE has been highlighted most recently in the context of the introduction of self-assessment. It has caused

concerns for employers in relation to accounting for small fringe benefits and expense allowances. These are being alleviated to some extent by administrative procedures but this is one impetus for simplification of the rules on expenses and benefits.¹

For many individual taxpayers, it is no doubt a great relief that they do not have to deal with their own tax affairs. However, citizens in other jurisdictions manage to submit annual tax returns, and the necessary support systems and agents have evolved to facilitate this. Some would argue that an extension of self-assessment is necessary to prevent discrimination against the majority of employees and that the long-term goal should be for them to take personal responsibility for their tax affairs.² The PAYE system can be seen as concealing important information from taxpayers or preventing them from understanding how much tax they are paying (Tyrie, 1996). As discussed below, it also makes reform of the substantive rules applicable to employees more difficult as it is complex to take account of individual circumstances under such a system. Some take the view that such an extension of self-assessment is inevitable (James, 1995), although in practical terms it is a long way off since there are such large numbers of employees as compared with self-employed.

A self-employed person is taxed on the annual profits or gains arising or accruing from his trade or profession under Schedule D. The computation of profit takes accounting profit as its starting-point, but this is subject to statutory provisions and, possibly, other principles of tax law.³ It is self-evident that a self-employed taxpayer cannot 'pay as he earns' in the same way as an employee, since he will normally draw up his accounts over an accounting year (which will not necessarily coincide with the tax year). A current-year basis is now to be used for the self-employed, rather than the preceding-year basis, so the rules on timing are less favourable for the self-employed than previously, although they can still be used to advantage where the business has a rising trend of profits. In addition, the self-employed pay tax on account only twice a year (on 31 January and 31 July, with a balancing payment on the following 31 January) and this gives a timing advantage over employees, from whom tax is deducted weekly or monthly. Although application of a cumulative PAYE system would be impossible in the case of the self-employed, ruling out complete alignment with

¹For example, the informal annual voluntary settlement procedure under which employers settled tax on some employees' fringe benefits and expenses by a single annual payment has now been formalised by the *Income Tax (Employments) (Amendment No. 6) Regulations 1996* (SI 1996/2631). Items covered by a PAYE settlement agreement will not need to be included in the returns of the employee or employer.

²Letter to the authors from Brian Shepherd CBE, formerly Assistant Secretary Inland Revenue and Secretary to the Keith Committee.

³*Gallagher v. Jones* [1993] STC 537.

TABLE 1
Employees and Self-Employed in Foreign Countries and the UK

	<i>How do you define employees v. self-employed?</i>	<i>Are there differences between tax law, employment law and social security law?</i>	<i>Is there deduction of tax at source for employees?</i>	<i>Deduction of tax at source for self-employed</i>	<i>Are there more liberal rules of expenses deduction for self-employed?</i>	<i>What differences are there in terms of social security (including pension) contributions paid and benefits received?</i>
UK	A common-law test based on particular facts of case. Some categories (e.g. lecturers) statutorily classed as employees for National Insurance purposes. Agency workers statutorily classed as employees for tax and National Insurance purposes.	Yes. Statute defines some categories as employees for National Insurance purposes but not for tax (and vice versa). Different judicial forums decide status for three tests. Attempts being made to align tax and social security administratively.	Yes — cumulative PAYE.	Only for building subcontractors and foreign entertainers.	Yes.	Employees and employers pay more than self-employed but do not receive commensurately higher benefits.
Australia	Common-law test but some specific statutory extensions (e.g. to cover entertainment industry).	Wider definition of employee for some retirement benefits purposes (e.g. labour-only contractors treated as employees for superannuation guaranteed purposes).	Yes — PAYE; a progressive graduated rate.	Withholding tax (PPS) at 20 per cent for self-employed in building, motor vehicle and cleaning industries. Other self-employed prepay in quarterly instalments. Deduction at source being extended.	Rules same but individuals must keep receipts. In practice, deductions easier for self-employed. No wholly and exclusively rule. Mixed expenses allowable for both categories.	Self-employed pay combined rates of employee and employer and receive similar benefits.

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Austria	Since July 1996, free-lance workers are a defined class for social insurance purposes. All categories defined in various statutes.	Yes — different definitions for tax, labour law and social security on workers although all but free-lance are broadly similar definitions. Free-lance workers are self-employed for labour law purposes but employees for social security purposes.	Yes — cumulative PAYE.	Twenty per cent deduction at source for free-lance workers. No deduction of tax at source for other self-employed.	Same rules. Any expenses in connection with work deductible even for employees but then must submit tax return.	Lower rates paid by self-employed but even self-employed (other than free-lance) have to pay approximately 30 per cent, which is slightly less than combined employee and employer rate. Same entitlement to benefits apart from unemployment benefit. Free-lance workers classified as employees for social security purposes.
Canada	Common-law test similar to UK and based on control and integration.	In some industries, some self-employed are treated as employees for unemployment insurance and labour law purposes (e.g. fishermen).	Yes — PAYE; a progressive graduated rate.	Payment on current-year basis in quarterly instalments. No deduction at source.	Much more limited deductions for employees. Must be required by contract of employment to bear them. Self-employed get deduction for all reasonable expenses laid out to earn income.	Canada Pension Plan — self-employed pay employee and employer share. Contributions to unemployment insurance not paid by self-employed, only employees and employers.

Continues overleaf

Taxation of Employed and Self-Employed Workers

	<i>How do you define employees v. self-employed?</i>	<i>Are there differences between tax law, employment law and social security law?</i>	<i>Is there deduction of tax at source for employees?</i>	<i>Deduction of tax at source for self-employed</i>	<i>Are there more liberal rules of expenses deduction for self-employed?</i>	<i>What differences are there in terms of social security (including pension) contributions paid and benefits received?</i>
Germany	Some self-employed persons defined in statute.	Mostly the same but some differences (e.g. managing director of limited liability company is employee for tax purposes but not for labour law purposes).	Yes — PAYE.	Limited deduction at source for a few categories (e.g. entertainers). Otherwise, quarterly payments on current-year basis.	Yes (e.g. on motor vehicle and car travel expenses).	Much higher rates for employees. Self-employed pay no compulsory social security payments but usually pay voluntarily. No benefits for self-employed unless pay voluntary insurance.
Netherlands	Civil law imposes a three-element test: obligation to work and to pay a salary and master–servant relationship.	Three categories of employment: public, private and fictitious employment.	Yes — cumulative PAYE.	Yes, for fictitious employment. Otherwise, pay on current-year basis.	Employees and self-employed claim tax reliefs on similar bases. Employees have standard deduction of 8 per cent of income up to a given maximum. No expenses with a mixed private / business element.	Basic pensions paid at same rate as part of income tax by employees and self-employed. Occupational security payments and medical expenses covering sickness and unemployment paid by employee and employer only.

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New Zealand	Common-law test.	Generally not.	Yes — PAYE.	Withholding tax at 15 / 20 per cent for certain categories (e.g. shearing insurance and commission agents; labour-only contractors in building industry).	Yes	—
US	Common-law test based on 20 factors. Some statutory employees (e.g. life insurance salesmen, homeworkers) and statutory non-employees (e.g. estate agents). Discussion that statutory test should be introduced for all employees and self-employed.	S.530 safe harbour rules in Rev. Act 1978 prohibit Revenue from correcting reasonable but wrong classifications of workers as independent contractors by employer but worker still employee for tax and labour law purposes.	Yes — payroll deduction adjusted for exemptions etc.	Payment on estimated current-year basis in quarterly intervals. No deduction of tax at source unless self-employed does not give payer a tax identification number, in which case 31 per cent withholding.	Must be 'ordinary and necessary'. Same test for employed and self-employed, but employed may only deduct expenses exceeding 2 per cent of gross income. In practice, deductions easier for self-employed.	Self-employed pay the combined employee / employer rates but receive commensurate benefits.

employees if cumulative PAYE is to be retained for them, some or all self-employed people could make more frequent tax payments during the year to reduce their cash-flow advantage yet further. This occurs in many other jurisdictions, where the self-employed make quarterly advance payments — see Table 1.

Here, the issue of collection merges into that of classification, since for some who fall within the current definition of self-employment, deduction at source, albeit not under a cumulative system, might also be practical. Some jurisdictions have adopted a form of deduction at source for certain categories of self-employed (see Table 1). In the UK, schemes for deduction at source operate in relation to subcontractors in the construction industry⁴ and some agency workers⁵ and foreign entertainers.⁶ The motivation for such schemes is usually to cut down on tax evasion (Soos, 1990).

2. *The Income Tax Base*

The self-employed taxpayer must prepare accounts in order to calculate a profit figure. He will decide for himself which costs should be incurred for the purposes of his business. Clearly, he will have some expenses; the question will be whether any are to be disallowed for tax purposes. The Schedule D rule sets out certain statutory disallowances. In particular, subsection 74 (1) (a) ICTA 1988 provides that no sum shall be deducted in respect of any disbursements or expenses, not being money *wholly and exclusively* laid out or expended for the purposes of the trade or profession.

Employees pay tax on their emoluments, which include certain benefits in kind and payments other than salaries. The legislation⁷ provides that employees' general expenses are deductible only if expended *wholly, exclusively and necessarily in the performance of the employee's duties*. In the case of travel expenses, the test is less onerous on the face of it, omitting the words 'wholly and exclusively'.⁸ 'Necessarily' has been construed as meaning that each and every occupant of the particular office or employment is necessarily obliged to incur the expense: a completely objective test.⁹ It is sometimes sought to justify this strict test on the basis that employers will pay or reimburse any truly necessary

⁴ICTA 1988 sections 559–567 and *Income Tax (Subcontractors in the Construction Industry) Regulations* 1993 as amended. A revised scheme is contained in FA 1996 section 178 but was never intended to come into force until August 1998. Implementation has now been further delayed.

⁵ICTA 1988 section 134.

⁶ICTA 1988 sections 555–558.

⁷ICTA 1988 section 189.

⁸In practice, this rule does not seem to have a more relaxed effect than the Schedule D rule, despite the decision in *Sargent v. Barnes* (1978) 2 All ER: see Macdonald (1978). Changes proposed in the 1996 Budget also relax the travel expenses rules for certain employees and could put them at an advantage over the self-employed in some circumstances (Budget Press Release, November 1996, REV 5).

⁹*Ricketts v. Colquhoun* [1926] AC 1.

expenditure. This contrasts with the position of the self-employed taxpayer, whose own decision carries more weight. However, the case law shows that a requirement by the employer to incur the expenditure does not always assist; neither does the fact that the employer reimburses the expense invariably prevent the sum from being taxable.¹⁰ Therefore, although at first sight this seems to be a difference in treatment that can be explained by a fundamental difference in the relationship under which the work is being carried out, the logic is not followed through in the application of the rules.

In any event, it has never been universally true that employers do pay all costs related to doing a job efficiently and well (see Royal Commission on the Taxation of Profits and Income (1955, para. 137)), and the current rate of change and development may mean that there is now a greater need than before for employees to maintain and develop their skills at their own expense and to incur expenditure on equipment to improve their work. The difficulties are exacerbated as working relationships become more complex and more flexible, and as new technology and improved transport enable employees to live far from their employer's offices.

The Courts have given the strict wording of the legislation applying to employees its full rigour, although the judges have tried to rest the responsibility firmly with the legislature. For example, Dankwerts J. said that the rule is

a very narrow and strict rule and it is one which undoubtedly causes a considerable amount of hardship when applied to particular cases. Judges dealing with particular cases have said so again and again. Their suggestions and observations, however, have either fallen upon deaf ears or perhaps have not reached the ears which are relevant to an alteration of the law, that is to say the ears of the persons who through the legislature decide these matters for other people.¹¹

He denied a deduction to a taxpayer who had a home office and needed to do so due to eyesight problems, since an office was provided by his employer. A self-employed person would be permitted to claim a portion of the costs of a home office in these circumstances.

The interpretation of the word 'necessary' in the UK cases may be contrasted with the approach of the courts in the US, where the same initial test applies to the employed and self-employed for deductibility of expenses. One condition of deductibility is that an expense must be 'ordinary and necessary', but necessary has been construed as meaning 'appropriate and helpful'.¹² It might be thought that the UK judges could have found a way to achieve a similarly more flexible rule on the wording in the legislation, but the precedents are too firmly set to expect any relaxation without legislation now. The Inland Revenue, in turn,

¹⁰*Brown v. Bullock* [1961] 3 All ER 129; *Smith v. Abbott* [1994] 1 All ER 673 at p. 683.

¹¹In *Roskams v. Bennett* [1950] 32 TC 129; see also *Brown v. Bullock*.

¹²*Welch v. Helvering* 290 US 111 1933.

applies the legislation and case law relating to deductions from employment income strictly, although there are concessions covering specific items.¹³ Successive governments have supported this strict rule which protects the tax base so successfully. However, the rule did not always apply to all employees, who were originally covered by Schedule D. A judicial decision led Parliament to transfer employees to Schedule E, with the incidental effect that the strict expenses rules became applicable; this does not seem to have been a careful design of Parliament (Monroe, 1981).

There does not appear to be anything fundamental in the employment relationship to inhibit a more relaxed rule on deduction of expenses. The real problems are cost and administrative difficulties. The strictness of the Schedule E rule in the UK is clearly consistent with the design of the cumulative PAYE system, which could break down under too great a number of adjustments for personal circumstances. In the US and other jurisdictions we have examined, it has been found possible to achieve rules for employees that are similar to those for the self-employed (see Table 1) but to limit employees' claims to alleviate the administrative difficulties and cost. In the US, employees may make certain deductions only if they exceed a specified floor, whilst the self-employed are not so restricted (Chirelstein, 1994). This is a difference that is connected with the method of tax collection and assessment, rather than the tax base.

There have been many criticisms of the harshness of the Schedule E rules and suggestions that they should be brought into line with those for the self-employed (Codification Committee, 1936; Royal Commission on the Taxation of Profits and Income, 1955; Institute of Taxation, 1989). The Royal Commission recommended substituting the following wording: 'all expenses reasonably incurred for the appropriate performance of the duties of the office or employment'. This can be criticised as giving too wide a discretion. The Institute of Taxation preferred a rule closer to that under Schedule D: 'all expenses wholly and exclusively incurred for the purposes of the office or employment'. As will be seen, this wording itself contains many limitations if strictly applied. It might be thought that this would be sufficient to prevent a major loss of revenue, but to date this type of development has always been resisted by government as too expensive.

Although considered to be less restrictive than the Schedule E provision, the Schedule D rules on deductibility of expenses have been construed by the judiciary as preventing the deduction of much expenditure that is classified as personal,

¹³For example, A1 (allowances for tools and clothing) and A64 (external training courses). ESC A63, which exempts employees from tax on some employer-funded training, is to be enacted and modernised (Budget Press Release, November 1996, REV 29).

such as clothing and food.¹⁴ Indeed, there are some instances where Schedule E deduction rules can be more relaxed than those under Schedule D.¹⁵

It should be noted here that there are some statutory provisions that are more generous to employees than to the self-employed. For example, the allowable contributions to pension schemes of employer and employee combined will often exceed the contributions allowable for the self-employed under personal pension plans. In addition, although most benefits in kind are now taxed in the hands of employees and the amount to be taxed has been coming closer to realistic levels in recent years (for example, in the case of company cars), in some cases there is still an advantage in receiving a benefit in kind, due to the method of valuation of that benefit. Some benefits, which would normally be personal expenditure of a self-employed taxpayer and so non-deductible, are covered by exemptions for employees — for example, certain relocation expenses¹⁶ and sports facilities.¹⁷

Despite these potential advantages for employees, it remains the case that it is often easier to make deductions under Schedule D than under Schedule E for three main reasons. First, the requirement under Schedule E that the expenditure be incurred necessarily in the performance of the duties is absent, so that the test is more subjective. This is in line with the notion that there is no employer to look to to decide whether the expenditure should be incurred.

Second, in practice, it appears to be easier to apportion costs under Schedule D, despite the fact that a strict construction of the words ‘wholly and exclusively’ might be thought to preclude this. Just how far this is concessionary and how far it is a question of application of case law is a matter for debate, but the differences do seem to exist and to be reflected in the Inland Revenue Inspectors’ Manuals, despite the fact that the wholly and exclusively rule is identical under each Schedule.¹⁸

Third, it may be that amounts wrongly deducted under Schedule D are not corrected during the assessment process. The Inland Revenue key work targets for 1996–97 aim to review the technical correctness of only 2 per cent of computations of the self-employed.¹⁹ The failure to pick up errors in one year may reinforce (mistaken) perceptions about what is deductible. In this way, a ‘folklore’ about deductibility can arise amongst those self-employed who do not take good tax advice. It is possible that the switch of onus onto the taxpayer under self-

¹⁴*Mallalieu v. Drummond* 1983 2 AC 861.

¹⁵See, for example, Brodie (1995) — site-based self-employed construction worker taxed on travel and accommodation allowances which would have been treated as tax-free under Inland Revenue Press Release, 13 February 1981, had he been an employee.

¹⁶ICTA 1988 section 191A and Schedule 11 A.

¹⁷ICTA 1988 section 197G.

¹⁸Contrast paragraph 601e of the Schedule D manual with paragraph 4491 of the Schedule E manual: a portion of the cost of rates and heating and lighting ‘may be regarded as allowable’ for a home office under Schedule D but is ‘strictly not justifiable’ under Schedule E; see further Freedman (1996).

¹⁹[1996] STI 840.

assessment may help to tighten up the strict application of the rules, but this new regime will highlight the need for the true extent of concessions and the correct interpretation of the rules to be made clear to ensure that this is fair²⁰ (Green, 1994; James, 1995).

The result is a perception that the rules regarding deductibility of expenses under Schedule D are much more relaxed than those under Schedule E. In so far as this does not reflect the true state of the law, it is an unhelpful belief that can only give rise to discontent. It also inhibits consideration of alignment of the rules which need not, in the end, result in such a great relaxation in the position for employees as might be expected. There would still be differences in application of the rule as between employees and the self-employed due to inherent differences in their situations, but the rule would operate on a continuum, sufficiently flexible to allow for variations in taxpayers' situations but without a clear dividing line in an arbitrary place.

To the extent that the rules are different at present, it is necessary to consider whether this reflects the underlying relationships or whether the strictness of the Schedule E rule is actually due to the desire to raise revenue and ease administration. If the reason for the rigour of the rule is the latter, it would be more logical to deal with these problems in administrative ways, as in other jurisdictions, rather than by having different substantive rules which are bound to create a sense of unfairness, particularly where an employee and a self-employed person are working side by side incurring similar expenses and undertaking similar duties.

The 1996 Budget responds to the pressure to modernise the Schedule E expenses rules by proposing amendments for certain types of travel expenses and by increasing the availability of deductions for training and putting existing concessions onto a statutory footing. These reforms will not apply to Schedule D taxpayers and may go a small distance towards reducing the feelings of unfairness experienced by employees. However, some commentators have criticised the narrow scope of the reforms, which do not address the more general need to update the expenses rules to meet modern conditions (Chartered Institute of Taxation, 1996; Institute of Chartered Accountants in England and Wales, 1996).

3. National Insurance Contributions and Benefits

The tax distinctions between the employed and self-employed are often dwarfed, in practical terms, by the differences in National Insurance contributions and benefit entitlements. Recent efforts to align the administration, operation and base of tax and National Insurance (Department of Social Security, 1993; Department of Social Security and Inland Revenue, 1994; Sandler, 1993), resulting from pressure to reduce compliance burdens, mean that any change that jeopardised the moves

²⁰TMA 1970 section 9.

towards the alignment already achieved would be very unlikely to be acceptable. Therefore any consideration of changes for tax purposes must also take into account the impact on National Insurance.

The original intention of the Beveridge plan was to include all citizens whilst taking into account different ways of life, including methods of earning.²¹ The scheme was to be contributory: that is, contributions were to be levied on an actuarially calculated basis to reflect the benefits received. However, payments are no longer linked clearly to prospective benefits, but are related to earnings. Nevertheless, the contributory principle remains important in that all those making payments have a contributions record on which eligibility for some future benefits is based, although this relationship is declining. This necessitates the keeping of detailed records showing the amount and class of contributions made. As well as being expensive,²² this is one of the factors that make it difficult to harmonise the tax and social security systems, even at an administrative level.²³

The position is that, in 1996–97, a self-employed person whose net profits exceed £3,430 pays Class 2 contributions at a flat rate of £6.05 per week and Class 4 contributions at 6 per cent on all profits above the ‘lower profits limit’ (£6,860), but only up to the ‘upper profits limit’ (£23,660). An employee pays Class 1 contributions at a rate of up to 10 per cent, depending on level of earnings (up to the ‘upper earnings limit’) and on whether he is contracted out of the State Earnings-Related Pension Scheme (SERPS). However, in the case of an employee, secondary Class 1 and Class 1A contributions are also made by the employer at variable rates and without any upper cap. These employer contributions, in particular, mark a fundamental difference between the two classes of worker and can make a significant financial difference, as shown in the example in Table 2.

The benefits available to these two groups also vary, as summarised briefly in Box 1, although the differences in benefit are not as much as might be supposed in the light of the variance between the contributions. In addition, employees may have rights to non-contributory benefits, such as industrial injuries benefit, which are not available to the self-employed. The advantage gained by the self-employed National Insurance contributor is recognised by government in its published estimates of costs of tax expenditures and structural reliefs. According to these, the value to the self-employed of reduced contributions that is not attributable to reduced benefit eligibility is around £2 billion (HM Treasury, 1996).

²¹Beveridge’s sixth fundamental principle: see Dilnot, Kay and Morris (1984, p. 32).

²²The cost of running the Contributions Agency, which administers the contributions records, is about £2,000 million per year: Johnson and Stears (1996).

²³Other difficulties are that maintenance of the contributory doctrine makes it difficult to accept the use of concessions for National Insurance purposes in cases where they would be applied by the Inland Revenue, and that taxation is levied annually, whether under cumulative PAYE or self-assessment, whilst National Insurance is non-cumulative so that it is necessary to deduct the right amount on an ongoing basis — Department of Social Security (1993) and Skinner and Robson (1992).

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TABLE 2
National Insurance Contribution Liabilities for Employees and the Self-Employed, 1996–97

<i>Annual earnings or profit</i>	<i>£ per annum</i>					
	<i>Employee, contracted in</i>	<i>Employer, contracted in</i>	<i>Total employer and employee</i>	<i>Employee, contracted out</i>	<i>Employer, contracted out</i>	<i>Self-employed</i>
£5,000	246.24	150.00	396.24	213.34 <u>32.90^a</u> <u>246.24</u>	95.16 <u>54.84^a</u> <u>150.00</u>	314.60
£10,000	746.24	700.00	1,446.24	623.34 <u>122.90^a</u> <u>746.24</u>	495.16 <u>204.84^a</u> <u>700.00</u>	503.00
£20,000	1,746.24	2,040.00	3,786.24	1,443.34 <u>302.90^a</u> <u>1,746.24</u>	1,535.16 <u>504.84^a</u> <u>2,040.00</u>	1,103.00
£40,000	2,112.24	4,080.00	6,192.24	1,743.46 <u>368.78^a</u> <u>2,112.24</u>	3,465.36 <u>614.64^a</u> <u>4,080.00</u>	1,322.60

^aContracted-out rebate.

Note: Employee and employer still have to pay the same sum overall but, in occupational schemes, employer and employee deduct the rebate from the contributions paid to the Revenue and pay it directly into the occupational scheme. Holders of personal pensions and their employers continue to pay the full not-contracted-out rate of contribution, receiving rebate from the DSS direct into the personal pension plan at the end of the year.

Authors at the Institute for Fiscal Studies have suggested that reform of self-employed National Insurance contributions might be a long-term aim of any government (Dilnot and Giles, 1996). Some degree of equalisation of payments and benefits between contracted-out²⁴ employees and the self-employed would be a technical possibility, without the need to address the more fundamental question of wholesale interaction of the tax and social security systems. The Canadian system, for example, appears to have addressed these problems, and other jurisdictions also have far less difference between the self-employed and employees than there is in the UK (Table 1). Obviously, removal of the structural advantage currently given to the self-employed would have distributional consequences, with the

²⁴Technically, SERPS could be made available to the self-employed but the complexity and cost of the scheme make its extension highly unlikely. Recent discussion has tended to focus, rather, on abolition of SERPS and its replacement by compulsory private funded pensions, although that would also present many difficulties: Retirement Income Inquiry (1996) and Blitz and Parker (1996).

BOX 1

Contributory Benefits Received by the Self-Employed and Employees

Jobseeker's allowance: The self-employed person will receive no contributory jobseeker's allowance. Employees will receive contributory jobseeker's allowance of £47.90 per week for 26 weeks. However, the self-employed person will be entitled to receive means-tested jobseeker's allowance for 26 weeks at £47.90 per week if annual income is less than £2,750 and capital does not exceed £2,500.

Statutory sick pay: The employee will be entitled to statutory sick pay of £54.55 (which is taxable) for the first 28 weeks if incapable of work. The self-employed person on the same earnings will receive no statutory sick pay but instead receive tax-free incapacity benefit at £46.15 for the first 28 weeks irrespective of unearned income or partner's earnings. The tests for whether someone is incapable of work are the same. Thereafter, both the self-employed and employees will receive the same amount of long-term incapacity benefit each week of £61.15.

Maternity benefits: The female employee will receive statutory maternity pay of £54.55 for 18 weeks and in the first six weeks will receive 90 per cent of average weekly earnings if more (so the higher the employee's earnings, the greater the benefit). The self-employed female will receive a flat-rate maternity allowance of £47.35 per week for 18 weeks irrespective of other income or partner's earnings.

Pension: All self-employed people and employees receive the basic state pension of £61.15 per week (assuming National Insurance credited contributions for approximately 90 per cent of working life) increased in line with prices (not earnings). The self-employed person receives no further state pension (unless based on a partner's contributions). Maximum SERPS benefits for non-contracted-out employees retiring after 2009 will be 20 per cent of band earnings.

Note: All benefits listed above assume correct contributions record to ensure full entitlement. Unless otherwise stated, no benefits listed above are means-tested.

richest fifth of the self-employed population losing, on average, £41.30 per week. Those in the lowest quintile would lose only £1.89 (Dilnot and Giles, 1996).

With the current advantage built into the system, it is inevitable that efforts will be made by some potential payers to be classified as self-employed, whatever the income tax position might be. Governments of all complexions are likely to wish to continue to provide incentives to entrepreneurs. The difficulty with the National Insurance advantage described here is that it is, on the one hand, unclear and somewhat hidden in the complexities of the social security system and, on the other, for those who are aware of the position, it invites attempts at manipulation of the definition of self-employment, as we shall discuss later in this article. Ministers might prefer to use the funds currently directed at this relief to give more direct and targeted assistance to entrepreneurs.

A more radical integration of the tax and social security systems is another alternative that could assist in eliminating differences in the treatment of taxpayers with different sources of income, but this involves major distributional and political issues which are beyond the scope of this paper (see Meade Committee

(1978), Dilnot, Kay and Morris (1984) and Dilnot (1995)).²⁵ Here, however, as in so many areas, the impossibility of addressing tax problems without considering National Insurance highlights the need for the systems to be developed together.

4. VAT

A self-employed person must be registered for VAT purposes if, broadly, his or her taxable supplies over a year exceed £48,000. VAT on supplies of goods and services must generally be accounted for on a quarterly basis and a self-employed person must keep detailed records and accounts for six years. Completing VAT returns has been shown to present a burden to the small self-employed person (Sandford, Godwin and Hardwick, 1989), although some businesses below the threshold register voluntarily. VAT registration can be an advantage, especially where there are VATable costs on which input tax can be recovered by a registered trader. Businesses with an annual value of taxable supplies not exceeding £300,000 may make an annual VAT return, and this scheme, for which take-up was low, has recently been enhanced. Returns are generally on the basis of invoices issued rather than cash received, which again can prove a burden for the self-employed, although about 150,000 businesses have elected for the cash accounting basis available to some small firms.

VAT is not payable in respect of the services provided by an employee to his employer. VAT considerations may sometimes pull against other tax considerations, therefore, by increasing the cost for a business of using an outside contractor rather than an employee where the business is exempt or partially exempt so that the VAT is not fully recoverable and because an individual taxpayer may prefer to be an employee rather than self-employed in order to avoid the hassle of VAT. However, a worker in this last category might well fall below the registration threshold in any event. 'Self-employed' staff are commonly used in some trades, for example hairdressing, to minimise VAT liability where the customers are private individuals who cannot recover the VAT paid.

IV. CLASSIFICATION

As discussed above, it is arguable that two individuals engaged *in similar economic activity* might be taxed to a different extent depending upon their classification as an employee or as self-employed. Yet it might be responded that, by definition, those classified differently are *not* engaged in similar economic activity. Whether this is correct depends upon the nature of the tests used to define the two groups and the extent to which they reflect a genuine difference.

²⁵The full integration of the National Insurance and tax systems was rejected by government in its Green Paper on personal taxation (HMSO, 1986), but it remains an objective of the Liberal Democrats as set out in a 1994 paper on tax and benefits.

1. The Legal Test

The distinction drawn by the cases is between a contract of service (employment) and a contract for services (self-employment). The legal tests evolved by the case law to distinguish between these two relationships are heavily dependent upon the particular facts of the case. The cases are drawn from many areas of law, not only taxation.²⁶ Initially, the cases were mainly concerned with control, reflecting their origins in the notion of the master–servant relationship, but the so-called ‘economic reality test’ in the *Market Investigations* case replaced this in the 1960s, heavily influenced by the jurisprudence of the US Supreme Court. The test for self-employment was then stated to be that the person must be performing the services as a person ‘in business on his own account’.

However, economic reality is notoriously difficult to capture in legal terms, particularly as work patterns move away from the standard model on which the legal classification was originally based (Stanworth, 1996, p. 28). It is particularly difficult to classify workers whose business consists of providing only personal services to another without providing any equipment or taking on their own employees. People in this category, sometimes called ‘own-account workers’ or ‘disguised wage labourers’ in the economic literature, are in fact marketing their personal skills in a manner akin to employment.²⁷ In 1993, an own-account worker was held to be self-employed by the Court of Appeal in *Hall v. Lorimer*. Whilst helpful to some taxpayers, this case illustrates the uncertainty that may arise over the guidelines to be used. The taxpayer was a vision mixer who worked for a number of studios. He had no equipment of his own, hired no staff and took no risks apart from those of bad debts and being unable to find work. Nolan LJ made it clear that there is no mechanical check-list that can be used and that factors of great importance in one case may be less so in another.²⁸ He went on to say that whether the individual is in business on his own account may be of little assistance in the case of one carrying on a profession or vocation (as opposed to a trade). Independence from a particular paymaster may be more important in such a case. The court in this case was concerned with the overall economic picture and not just the terms of one particular engagement.²⁹ In this sense, the test propounded was not easily manipulable. Yet it can be seen that an employed vision mixer (possibly on a short-term contract, at risk of unemployment and of not being paid in full if the employing company went into liquidation) might be forgiven for

²⁶Some of the leading cases are *Davies v. Braithwaite* [1931] 2KB 628, *Market Investigations Ltd v. Minister of Social Security* [1969] 2 QB 173, *Fall v. Hitchen* [1973] STC 66 and *Hall v. Lorimer* [1994] STC 23.

²⁷Storey and Johnson (1987). See also Hollander and others (1967), who distinguish ‘little businesses’ from ‘full-functioning businesses’ — but say ‘this borderline is necessarily imprecise and differs with the nature of particular businesses’.

²⁸This was echoed in *Barnett v. Brabyn* [1996] STC 716.

²⁹To an extent, this marks a move away from the approach in *Fall v. Hitchen*, where the emphasis was on analysis of one particular contract, and back to *Davies v. Braithwaite*, where the engagement was examined in the context of the taxpayer’s other activities.

thinking it unfair that he should pay more tax and National Insurance than his 'self-employed' colleague in such circumstances.

The changing work patterns described below make it likely that this type of situation will arise more frequently now than in the past. Particular difficulties arise in the oil, construction and computer industries, with homeworkers and teleworkers, and with actors, television workers and journalists.

2. Problems with the Legal Test

Uncertainty

The fluidity of the test and the impossibility of drawing up a check-list prevent manipulation in some cases. Nevertheless, in borderline cases, contracts can be designed with status in mind, so that people in broadly similar, if not formally identical, economic circumstances will be treated differently for tax and National Insurance purposes. At the same time, the lack of conclusive criteria may leave some business owners, particularly those in industries where there is a great deal of casual working, in a state of uncertainty that can cost them time and also a great deal of money if they misclassify a worker.³⁰ They may feel under pressure to adopt a particular classification because that is being done by others in their industry and not to follow the general practice would put them at a competitive disadvantage.

Guidance can be obtained in such circumstances from the Inland Revenue and the Contributions Agency, which issue a leaflet (IR56/NI39) and have nominated status officers to deal with such enquiries. Arrangements are in place to facilitate liaison between the two organisations on these questions and these are said by those organisations to be working well (Department of Social Security and Inland Revenue, 1994). However, it can take some time for such guidance to be obtained. The Inland Revenue Adjudicator's Office has dealt with some complaints related to the length of time it has taken to determine status, cases that show the difficulties that can be caused to taxpayers by uncertainty on this point.³¹ In a recent study of compliance costs, 47 per cent of tax practitioners responding to a questionnaire had had discussions with the Inland Revenue about status issues and 83 per cent of these felt that the amount of correspondence could have been reduced if 'the relevant law had been clearer' (see Green (1994, p. 35)). About

³⁰If a worker is wrongly classified as self-employed, the employer may become liable for income tax and National Insurance arrears.

³¹See Adjudicator for the Inland Revenue (1995) Case A7: K provided services to a company which deducted tax under PAYE. According to the Inland Revenue's own industry guidelines, K should have been treated as self-employed. The Inland Revenue took five months to send a definitive reply confirming self-employed status but even then ignored the question of PAYE repayment until almost a year after the initial letter. The Adjudicator assisted K to obtain compensation.

25,000 status queries go to local contributions agencies each year (although some of these are very basic).³²

Construction Industry: An Example

A clear and topical example of the uncertainty felt over status, despite attempts by the Inland Revenue and Contributions Agency to provide guidance, is to be found in the construction industry. Although there is a special scheme for taxing subcontractors in this industry by way of deduction at source,³³ this was always intended to apply only to those who were self-employed under the common-law tests. In practice, some contractors have been operating the deduction system without considering whether a worker was genuinely self-employed. Because tax was being deducted at source, the loss to the Inland Revenue was not very great (lying mainly in the different expenses rules). However, there is a loss in National Insurance contributions collected, since the subcontractors covered by the scheme are treated as self-employed for this purpose. The costs are not all one way. Workers dealt with under the subcontractors scheme who should be classified as employees lose out on benefits, training and, possibly, protection under employment law.³⁴ Larger contractors who want to employ their work-force and make the appropriate National Insurance and tax payments complain that they are being undercut by those not following this course.

In co-operation with the construction industry, for the reasons set out above, the Inland Revenue and Contributions Agency have decided to pursue more rigorously the question of whether workers are employed and so not eligible to be taxed as subcontractors. A leaflet was issued for guidance (IR148/CA69) but much concern appears to have been generated in the industry, as a result of which more time has had to be given for contractors to review the employment status of their workers and a helpline has been set up to provide assistance with employment status queries (Inland Revenue Press Release, 19 November 1996). The operation of the special regime as if it overrode the common law actually assisted many employers, but now that they must consider the interaction between the common law and the special regime, there are more uncertainties.

Different Applications and Developments of the Legal Test

The tax literature largely focuses on the savings that can be made by classification as self-employed. However, the employment law literature shows the other side of the story. Some low-paid workers would prefer to be employees in order to obtain

³²Interview with DSS (Policy). The Inland Revenue does not collect equivalent figures. Anecdotal evidence from practitioners raises questions about the effectiveness of the liaison arrangements between some local offices and refers to delays. This is an issue on which evidence is invited.

³³ICTA 1988 sections 559–567; to be amended by 1996 Finance Act and regulations thereunder (amendments not yet in force).

³⁴Although industrial tribunals might still decide that there is a contract of employment. See also Harvey (1995).

the protection of employment legislation and social security benefits (Harvey, 1995; Stanworth, 1996) and to avoid the administrative burden of being responsible for their own tax affairs. On the whole, businesses save costs by using contractors rather than employees, and the present tax and National Insurance provisions reinforce the effect of employment law in this respect. There are, of course, commercial reasons why businesses might prefer employment, such as obtaining a loyal and well-trained work-force, but the incentives in the opposite direction are strong.

The problem of uncertainty of status is compounded by differences in application between industrial tribunal decisions and decisions in tax cases. Although, in theory, the factors and tests are the same,³⁵ subject to the statutory differences discussed below, the different issues being considered by the tribunals are bound to affect the way in which they weigh up and balance the factors, a fact that is recognised by the latest version of IR56/NI39. A major difference is that disputes about employment rights and, sometimes, National Insurance benefits will often arise after the event, whilst tax and National Insurance contributions are ongoing issues, so that the context of the hearings and the interests of the parties may vary.

So, for example, it has been held by the Employment Appeal Tribunal that a worker who had provided his services through a limited company was an employee for unfair dismissal purposes, even though the company was set up so that the worker could avoid being treated as an employee for tax and National Insurance purposes.³⁶ The taxpayer would have argued the case quite differently during the currency of the arrangement. Another example is the recent case of Mrs Patel, a homeworker. She was ruled to be an employee by the Industrial Tribunal when she sued the company supplying her with work for unfair dismissal, but held to be self-employed for tax purposes by the General Commissioners.³⁷ Her application for unemployment benefit is still being investigated by the Contributions Agency. If it were to agree that she had been employed, she might qualify for benefit, subject, perhaps, to deduction of primary Class 1 National Insurance contributions,³⁸ but if the Agency were to treat her as self-employed, she would be liable to pay Class 2 National Insurance contributions and would not be entitled to any contributory benefit.³⁹

³⁵*Young & Woods Ltd v. West* [1980] IRLR 201; although see *O'Kelley v. Trust House Forte* [1983] 3 All ER 456 at p. 461, where the Industrial Tribunal accepted and the Court of Appeal did not dispute that the fact that tax and social security contributions were required to be deducted by the Inland Revenue was not, of itself, indicative of the legal relationship for employment protection purposes.

³⁶*Catamaran Cruisers Ltd v. Williams* [1994] IRLR 386.

³⁷Brodie (1996) and further information supplied by Leicester Outwork Campaign.

³⁸The Agency could pursue the employer for the unpaid contributions (sections 114 and 119 *Social Security Administration Act 1992*) and in some circumstances payments can be credited or backdated (Part IV, *Social Security (Contributions) Regulations SI 1979 no. 591*).

³⁹A third mechanism for deciding Mrs Patel's status could be brought into play under section 17 of the *Social Security Administration Act 1992* as described below.

The problem is that, whilst it would be illogical for the National Insurance and tax positions to be different, it would appear equally unreasonable for the Contributions Agency to deviate from the Industrial Tribunal in a matter of unemployment benefit. One of the least desirable outcomes is to have the same tests applicable in theory but to find that they are differently applied in practice, so that different agencies are treating the same worker in different ways without any clear rationale. Yet this seems to occur in some cases in the UK at present. Whilst we have evidence of some cases where this has occurred, further evidence is needed of the extent to which this is taking place.

Appeals

Whilst steps have been taken to bring the tax and National Insurance approaches into line, the appeals systems for the two still differ, with tax appeals going to the General or Special Commissioners and National Insurance status questions going to the Office for Determination of Contribution Questions (ODCQ).⁴⁰ This has led the Tax Law Review Committee (1996) to suggest that consideration should be given to referring National Insurance questions, and particularly status issues, to the tax tribunals. This would appear sensible, since the relevant definition should be the same in each case, except where there are specific statutory differences, which could be preserved in such a system if this were felt necessary.⁴¹ The response to this might be that the ODCQ has to consider benefits issues as well as contributions and that the tax tribunals are not appropriate for this purpose. In addition, uniting the tax and social security tribunals would solve only part of the problem. Industrial tribunals also hear worker categorisation cases in the context of employment rights, sometimes coming to different conclusions from the tax tribunals, as described above. If the issue of status arose in the context of unfair dismissal, for example, it would be undesirable for the worker to have to go to one tribunal to consider his status and to another to consider unfair dismissal. Equally, if the Industrial Tribunal did decide he was an employee, it would seem hard that he should have to endure another determination of status before a decision was made as to whether he was entitled to unemployment benefit. So, although it would seem attractive to have one tribunal with jurisdiction to consider status issues, combining all three jurisdictions would seem very difficult in view of the different issues and different make-up of the tribunals. This requires further investigation.

⁴⁰Under section 17 of the *Social Security Administration Act 1992*.

⁴¹Certain types of worker (for example, office cleaners, some agency workers and lecturers) are categorised as employees for National Insurance purposes regardless of their position at common law: *Social Security (Categorisation of Earners) Regulations 1978*, SI 1978/1689. North Sea divers are excluded from Schedule E by ICTA 1988 section 314.

Changing Work Patterns

The classification problem has been with us for many years and it might be questioned why reform should be needed now, after so much experience and case law has been built up. Should this be disturbed?

One reason why the current divisions are coming under pressure now is that work patterns are changing away from the standard model, with more flexible working. The cumulative PAYE system, designed to deal with permanent, long-term employment, is now having to cope with short-term contracts, casual workers and more frequent movement into and out of employment. There has been an increase in self-employment from under 2 million in 1979 to 3.3 million in 1994–95 (Institute for Fiscal Studies, 1993; Government Statistical Service, 1996). The vast bulk of businesses in the UK (around 2.5 million) are made up solely of one or more self-employed people with no employees. Many of these self-employed persons are supplying labour and skills, and some would have been employees in the past (Department of Trade and Industry, 1996). It has been predicted that ‘The character of work will continue to change, albeit not so rapidly as in the past 20 years, with significant increases in part time working, self-employment and exposure to unemployment’.⁴² There is also evidence of an increase in homeworking over the last decade (Stanworth, 1996), another development that may well continue as a result of both economic factors and technological change.

The increase in non-standard working results in difficulties where workers are treated as employees so that the full complexity of cumulative PAYE must be brought to bear. This has led to special arrangements being made to modify the operation of PAYE in the case of some occupations, such as market research interviewers.⁴³ Where these non-standard workers are treated as self-employed, they will often lose out on benefits. In addition, there may be an increase in tax evasion due to the lack of deduction at source (Soos, 1990). It is the loss of revenue in such cases that led the Keith Committee (1983, para. 6.3) to recommend that deduction at source should be applied to certain casual workers under a non-cumulative scheme. This problem of ensuring that certain labour providers are fully taxed is not unique to the UK, as can be seen from the recent creation of a special regime for ‘free-lance workers’ in Austria, the existence of ‘fictitious employees’ in the Netherlands and the extensions of withholding found necessary in Australia and New Zealand (see Table 1).

V. OPTIONS

We have set out some problems with the current system above but have also tried to indicate the complexities that make reform difficult. The two main routes to

⁴²Lange and Atkinson (1995); see also Gregg and Wadsworth (1995).

⁴³Regulation 102 of the *Income Tax (Employments) Regulations* 1993.

reform would be to bring the rules applicable to the employed and self-employed closer together and, in addition or alternatively, to alter the boundaries between the categories. Some possible suggestions for movement in this direction are listed for discussion. Some are alternatives and others cumulative; some involve major changes whilst others are not so radical.

1. Aligning Rules

- Reduce the differences between the rules on deductibility of expenses under each Schedule.
- Increase the frequency of payments on account of tax by the self-employed.
- Apply non-cumulative deduction at source to various workers, both 'employed' and 'self-employed'.
- Bring the National Insurance contributions (and benefits) of the employed and self-employed closer together.

Expenses

It would be possible to align the rules on deductible expenses, as in some other jurisdictions (see Table 1) and as has been proposed previously in the UK. The precise wording would require considerable consultation and discussion. A rule along the lines of that under Schedule D is strict enough to prevent much expenditure from being deducted due to the wholly and exclusively rule, so that fears of opening a floodgate may be exaggerated. The position on apportionment would need to be clarified.

The objections to alignment are those of cost and of administrative complexity in the affairs of employees taxed by deduction at source. However, aligning the rules does not necessarily mean that they must be relaxed in every direction: revenue savings could be achieved by tightening some rules for the self-employed and limiting the apportionment of expenses in practice where a personal benefit is obtained.

Complexity is more of a problem. Since the majority of employees currently do not complete a tax return, permitting more relaxed deduction of expenses would increase the number who do so. Some would argue that this is an inevitable and even desirable development in the long run. In the short term, it would not be manageable, but in the medium term, those who wished to claim expenses could make a return under the self-assessment system and, perhaps, should have a right to do so.

Two methods in particular have been suggested to us of limiting the administrative and compliance costs of relaxing the expenses rules for employees:

- (a) There could be a standard expenses deduction for all employees. Expenses greater than this would have to be individually claimed and proof given, but the standard deduction would be available without proof and could be dealt

with through PAYE coding. This would limit those having to make tax returns to those with non-trivial expenses. However, there would be a dead-weight cost in that many employees would receive an allowance for expenses they had not incurred. In effect, this would develop into an additional personal allowance for employees, recognising costs (such as clothing and travel) that are not necessarily costs of their work in the strict sense but that affect their ability to pay tax. Since this could cover expenses not strictly deductible even under a new relaxed test, the self-employed would then complain that they were losing out because they would almost always itemise expenses. Those with only investment income, including pensioners, would also not receive this allowance. The Royal Commission on the Taxation of Profits and Income in 1955 rejected a standard deduction on the basis that it 'could see no possibility of deciding what to suggest as the amount of such a lump sum or percentage'. The amount would have to be low to be realistic. Alternatively, it could be related to earnings, as in the Netherlands (see Table 1).

- (b) An option that might be preferable to (a) would be for the first tranche of expenses to be disallowed, up to an amount the level of which would be for discussion. This would reduce the number of employees deducting expenses but allow those with special needs to do so. In the US, certain miscellaneous itemised deductions are allowed in the case of employees only to the extent that they exceed 2 per cent of the taxpayer's adjusted gross income. This eliminates deduction of small-scale outlays and so reduces the audit burden. However, especially in the case of high earners, this may mean that expenditure genuinely incurred cannot be deducted and this operates as an incentive for higher-paid taxpayers to arrange their affairs so that they are classified as self-employed. For this reason, the disallowance should also be applied to the self-employed to prevent distortion and to claw back some of the cost of the relaxation.

Increased Frequency of Payment

The number of payments on account of tax made in a year by the self-employed could be increased to further reduce their timing advantage, in line with many other jurisdictions — see Table 1. This could be seen as increasing the burden on the self-employed but would be a move in the same direction as the introduction of the current-year basis for the self-employed, one of the stated objectives of which was to align the system of collection from the employed and the self-employed more closely (Institute for Fiscal Studies, 1993, p. 18). A survey conducted by IFS found that a majority of self-employed taxpayers questioned actually wished to pay tax more frequently than at present, with 25 per cent wishing to pay monthly and 38 per cent quarterly (Institute for Fiscal Studies, 1993, p. 42).

Non-Cumulative Deduction at Source

Non-cumulative deduction at source, instead of cumulative PAYE, could be applied to specified non-standard employees. This would be an extension of administrative provisions already in place. In addition, non-cumulative deduction at source could be applied to some self-employed people, particularly those who work primarily for one or two principals and supply labour only. This would in effect be an extension of the system currently used for subcontractors in the construction industry in the UK and is in line with developments in other jurisdictions — for example, Australia, Austria and the Netherlands.

Extension of non-cumulative deduction at source would reduce tax evasion amongst the self-employed and cut down the administrative burden of PAYE where it is least appropriate (for example, where there are multiple, casual or short-term employments). It would recognise the economic equivalence of the service providers at the borders of the employed and self-employed groups. The extension of non-cumulative PAYE for some currently taxed as employees would bring this group into the self-assessment system. Many of them will need to have their tax adjusted at the end of the year even if cumulative PAYE is attempted, in view of the complexity of their situation, and so the self-assessment regime is the most appropriate for them. To those who argue for an extension of self-assessment to all in the long term and an abandonment of cumulative PAYE, this could be a step on the way.

Deduction at source for some self-employed people might be seen as a burden on business. This is a question of the system set up and the clarity with which those falling within it can be defined and identified. Certainty may be the most important issue here. The interaction between the deduction-at-source regime and the common law is therefore important, as can be seen from the construction industry experience in the UK. The new regime might need to override the common law in some cases to avoid *increasing* uncertainty for business. The main problems would be definitional. A recent Bill in Australia to clarify the extension of PAYE beyond common-law employees was abandoned as a result of complaints that it would have unintended consequences. It would be important to apply the new regime where it was administratively sensible on the basis that withholding from the self-employed, just as for employees, was simply a convenient method for collecting tax owed, rather than it being seen as a punitive measure, which should be reserved for non-compliant taxpayers. This would reduce pressure for exemptions, which themselves cause complexity (Soos, 1990).

National Insurance Payments

Total integration of National Insurance and taxation would clearly align the positions of the employed and self-employed in this respect, but it raises questions that go far beyond the scope of our paper. Short of this, however, the actual payments made by the self-employed could be brought closer to those made by the

employed by increasing them as suggested above or by reducing employee and employer payments and bringing the benefit entitlements of the two groups as close together as possible. If the contributory principle is to be maintained, then it is logical for the payments made by each group to relate more closely to their actual benefit entitlements. The discrepancy between the employed and the self-employed in the UK appears to be greater than in a number of other jurisdictions we have studied.

2. Classification

The greater the success of the alignment measures discussed above, the less pressure there will be on status decisions. However, whilst differences in the rules remain, there will be difficulties at the border. These difficulties create cost for business in so far as there is uncertainty and encourage manipulation of the definition to achieve the desired tax result. The current situation reinforces the incentive under employment law for some businesses to take steps to make their workers self-employed, resulting in increased job insecurity for certain groups of workers.

Some possible approaches would be:

- statutory definition of employment and self-employment;
- delinking of tax definition from other areas of law and creation of new categories;
- aligning definitions in different areas of law further and bringing appeals procedures within the jurisdiction of one tribunal.

Statutory Definitions

A statutory definition of employment and self-employment could be attempted. However, examples of such attempts in other jurisdictions are not encouraging. Recent evidence before a subcommittee of the US House of Representatives Committee on Ways and Means (June 1996) shows the difficulties of drawing up a list of objective criteria. Our own case law also demonstrates the difficulty of producing universally applicable criteria. Even a statutory definition would leave hard cases at the border and it could be more, rather than less, open to manipulation than the current case law.

New Definitions Delinked from General Law

The definitions used for some tax purposes could be delinked from those used in other areas of law, such as employment law (see Los Angeles County Bar Association (1992)). This would recognise that the purpose of the definition is different in different situations, a matter that is *de facto* recognised by the different approaches of the tax and employment tribunals. Commercial reasons for

preferring one type of relationship or another would not be distorted by tax considerations.

Complete movement away from the common-law definition for tax purposes would necessitate a statutory definition, which is likely to prove difficult, as discussed above. In any event, National Insurance contributions payments cannot sensibly be delinked from employment-law status whilst we have different benefit entitlements for employees and the self-employed. Complete delinking looks unlikely to be attractive. However, there is no reason why the administration of tax should not move away from the common-law definition for some purposes. The method of collection of tax, for example, could be based on objective tests linked to the practicality, efficiency and convenience of deduction at source. The proposals above for extension of non-cumulative deduction at source would reduce (but not eliminate) the importance of the common-law definition by providing a bridge between the employed and the self-employed.

Alignment of Appeals Mechanisms to Bring Definitions Closer Together

To the extent that the test of employment and self-employed status is supposed to be the same in different areas of law, steps could be taken to ensure that the application and development of those tests do not deviate in the different areas. Consideration could be given to bringing tax and National Insurance status decisions under the jurisdiction of one tribunal. The problem of alignment with employment law must also be taken into account and is more difficult since the issue of status will arise in such different circumstances for these purposes. But the relationship between the tests could be clarified.

3. Minor Reforms

If alignment of the rules applicable to employees and the self-employed proves impossible or unacceptable, there are some minor changes that could assist taxpayers and business owners, although these would not deal with the more fundamental problems.

For example, employees could be permitted to claim a standard deduction for expenses, without any further change to the expenses rules. This would, however, meet with the objections discussed above in relation to such a scheme, although, if not combined with an alignment of rules, it would be easier to argue that the deduction should be available only to employees and not to the self-employed. So this approach might help to reduce impressions of inequity as between the employed and self-employed but it would not prevent those employees with particularly heavy expenses from feeling aggrieved, since they would still be denied deductions available to the self-employed.

Another area that could be tackled separately from more radical reform is the discrepancy between the strict position on expenses rules and that in practice. On its wording, the Schedule D rule would appear to exclude some expenditure that is

currently allowed in practice in whole or in part. The legislation could be rewritten to clarify the position on apportionment, in particular, by incorporating concessions where appropriate. Consideration could then be given as to whether there was any justification for making certain concessions available to the self-employed but not the employed on the law as it currently stands. Increased policing of the expenses of the self-employed might also have a part to play in decreasing perceptions of unfairness.

VI. CONCLUSIONS

The problems discussed here, which at first sight appear to have arisen for historical, almost accidental, reasons, in fact reflect a more fundamental difficulty which is found in other jurisdictions whose systems have developed separately. Sensible proposals for reform are frustrated not only by cost considerations but also by the interplay between different parts of the tax and benefits system. Moving one piece of the jigsaw requires a rearrangement of many other sections. In the space available, we have only been able to give an overview of the issues. More detailed work is in progress. It is clear that any reform in this area will have distributional consequences and might also have a revenue cost. In the long run, therefore, there are political decisions to be made. Social and economic circumstances are such that pressures on politicians to make changes in this area are likely to continue and even increase, and the aim of this exercise is to assist policymakers to see the complexity of these interrelated areas and assess the impact of their policies.

The authors now intend, on behalf of the Tax Law Review Committee, to consult with representative bodies and groups of taxpayers, advisers and business owners to test which of the above perceived problems, if any, are causing them difficulty and which options for change merit further attention. Comments, information and suggestions are welcome from any quarter. Please contact the authors, at the addresses on the opposite page, with your views.

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