

# **EMPLOYED OR SELF-EMPLOYED?**

## **TAX CLASSIFICATION OF WORKERS AND THE CHANGING LABOUR MARKET**

DISCUSSION PAPER

JUDITH FREEDMAN

IFS Research Fellow and Professor of Law, London School of Economics

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The Tax Law Review Committee  
The Institute for Fiscal Studies  
3<sup>rd</sup> Floor, 7 Ridgmount Street  
London WC1E 7AE  
(Tel: +44 (0)20 7291 4800)  
(Fax: +44 (0)20 7323 4780)  
(email: [mailbox@ifs.org.uk](mailto:mailbox@ifs.org.uk))  
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## EXECUTIVE SUMMARY

1 This paper discusses part of a project undertaken at the request of the Tax Law Review Committee (TLRC), which has been considering the issue of tax equity as between the employed and self-employed. The paper should not be taken to represent the views of the TLRC.

2 The **Introduction** to this paper sets out the background to the TLRC project and the parameters of this paper. The questions addressed by the *TLRC project* relate to two main areas:

- **Classification.** What problems, if any, are caused by the current classification of workers into employees and the self-employed for tax purposes and how sensible is that classification in modern economic conditions? Could a better system of classification be devised for this purpose?
- **Alignment.** How far could and should the tax and National Insurance contributions (NICs) position of these two groups be aligned?

3 *This paper* looks primarily at the issue of classification. This is not because the question of alignment is any less important. Clearly, if tax and National Insurance differences between the groups of workers could be removed, classification would become less important. The issues need to be examined in stages, however, since alignment may not be necessary or desirable if there are real differences between the two groups of workers.

4 The question of alignment of treatment raises fundamental questions about the way tax is collected in the UK and the true role of the National Insurance system. Radical reform, such as integration of tax and NICs or changes to the PAYE system, *might* be the only way to eliminate completely the problems of equity as between the employed and self-employed. Other issues of importance are methods of tax collection and differences in rules on computation. These issues are all alluded to but not addressed in detail here.

5 This paper should not be taken as a comment one way or the other on the desirability of these reforms, but it is important that all these issues continue to be discussed and researched. Whilst this wider work continues, however, the TLRC feels that publication of this discussion paper purely on classification issues is timely and helpful in the light of recent tax and employment law developments.

6 **Chapter 1** describes some of the problems encountered in trying to classify workers. Workers cover a broad spectrum. At each end of this spectrum, the features of the employed and self-employed can be clearly distinguished. The unequivocally self-employed person will be running a business on his own account, bearing the risk

of loss, investing capital and independent of his clients. It would be impractical, if not impossible, to deduct tax at source from his gross income.

7 An unequivocally employed person will receive a wage or salary. He is more likely to be subject to some kind of direct supervision and will be integrated into the business to which he is supplying his services. It will be practical and convenient to require the employer to deduct tax at source from such an employee, and a cumulative PAYE system will work well.

8 There are workers who do not fit either of these two descriptions precisely, but lie somewhere between the two ends of this spectrum. They may be described as occupying a ‘grey area’ at the borderline of the classification divide. Such workers may find themselves classified differently for different legal purposes.

9 Some differences in rules may operate unfairly even as between workers clearly and properly classified on one side or other of the divide. For example, some unequivocal employees will incur genuine expenses that they cannot deduct for tax purposes under current rules. It is in relation to the group in the grey area, however, that the question of inequity between the employed and self-employed is most likely to be raised. Chapter 1 illustrates the difficulty of comparing workers playing different economic roles and fitting them into legal classifications where those classifications result in different tax and other consequences.

10 Removing the differences in tax and NICs treatments between different groups could reduce these classification problems. The examples discussed in Chapter 1, however, show that there are real differences at each end of the worker status spectrum. It would be very difficult, and not always practical or helpful, to *remove* all differences in treatment, though *reduction* of the differences might be possible. This paper, however, concentrates on classification.

11 While it is inevitable that the focus is on the ‘hard cases’, it must be remembered that the vast majority of the working population will fall clearly within the category either of employed or of self-employed. Any proposals for reform of classification issues must bear this in mind and must not unsettle the position of the many for the sake of the few, for example by creating multiple classifications that would engender more, not less, uncertainty.

12 **Chapter 2** examines the evidence on changing work patterns and considers the implications of this for the legal rules on classification. Working patterns have changed significantly over the past 20 years. There are now more non-standard workers than previously: self-employed, part-timers and short-fixed-term workers. Not all these workers present problems for the tax system but some are at the borderline of the employed/self-employed classification. This classification was developed when employment patterns were generally more stable and straightforward.

13 The increase in all types of non-standard work poses challenges to the legal system of classification. Most people are still in standard work and this may well

continue to be the case, but increasing numbers are wholly or partly engaged in variations of this standard pattern. In addition, a high proportion of businesses in the UK are sole traders or partnerships without employees. Many of these will be 'grey area' workers.

14 In a tax context, this has two main consequences. First, the number of workers at the borderline of the employed and self-employed classification has increased. This puts pressure on the borderline that is drawn in the case law. It increases the problems where very different tax consequences flow from classification. It places a heavy weight on this case law classification and on the courts to make it coherent and as far as possible in tune with reality, whilst maintaining a degree of certainty. The high proportion of self-employment without employees in the business population creates difficulties for a government that wishes to target 'entrepreneurs' or 'genuine businesses' for reliefs and allowances, but to exclude those it perceives to be 'disguised wage-labourers'. The difficulty of drawing such a line is discussed in Chapter 2 and throughout the paper.

15 Second, even where classification is not an issue because a non-standard worker is fairly clearly on one side of the line or the other, the rules developed for standard workers may not fit easily with the increasing number of those who do not follow the standard pattern. Cumulative PAYE, the expenses rules and NICs record rules are all examples of this problem.

16 **Chapter 3** considers the UK case law on employment status in detail. The approach of some other jurisdictions is also considered briefly. Unlike sociological or economic analysis, which may accommodate the notion of hybrid workers more easily, legal classification of workers must place them on one side or the other of the employed/self-employed boundary. This places great strain on decision-making where complex factual situations are concerned. The chapter analyses the case law on worker status in the areas of income tax, NICs and VAT. A comparison is made between the approach of the courts in tax and in employment law cases.

17 In the UK, great weight is placed by the courts on the facts of each case and there is no definitive list of factors or weighting of those factors to be taken into account. If workers are seen as stretching across a continuous spectrum, then this fact-based jurisprudence accords with reality and gives the courts the best chance of adapting the law to changing work patterns. It also prevents the definition of an employee or self-employed person from becoming formulaic, which could result in manipulation. At the same time, the law needs to provide guidance and certainty. Any unwillingness of the courts to formulate status decisions as questions of law may make certainty more difficult to achieve and may place a burden on the Inland Revenue, business and workers alike.

18 At first sight, the case law tests for determining the status of workers might seem to be outdated and too uncertain to be of real value. It has been suggested that a simpler, clearer test is needed but no one has been able to suggest such a test. The variety of working patterns that exists makes it impossible to devise a simple test.

Objective tests such as the number of clients/employers for whom work is done would be easily manipulated if they were stated categorically and rigidly. As commented by the Tax Law Rewrite Team, any statutory test would need to list factors or badges to be considered in much the same way as the case law does. It is questionable whether anything would be achieved by any such statutory listing.

19 It is significant that no simple statutory test seems to have been devised in the other jurisdictions examined. Many common law countries have a list of factors similar to those in the UK. Where countries do use statutory definitions of employees or ‘disguised employees’, they often utilise concepts such as dependence, entrepreneurship or running a business, which raise as many issues as does the use of the concept of a contract of service. Nevertheless, statutory clarification of definitions for some groups of workers, or legislative ‘safe harbours’ for particular groups, as used in some jurisdictions, can be helpful in shifting the burden of proof and providing a practical level of certainty. Inland Revenue guidance is also discussed.

20 The value of the case law should not be underestimated. The courts have shown an ability to adapt to changing working conditions in cases such as *Hall v Lorimer* and to lay down some guidelines. There is, however, considerable uncertainty at the margins about worker classification under the case law. It can be confusing also that, whilst the employment law, insurance, tort, income tax, VAT and National Insurance cases all appear to start at the same point and cite the same authorities, the different contexts in which they are heard seem to result in the development of subtly diverging case law. The assumptions and policy objectives of the different courts, whether they are express as in some cases or merely implicit, do appear to affect their decisions.

21 The case law tests have been given a central role under the personal service intermediaries legislation. The controversial nature of this legislation and the fact that litigation has been threatened do suggest that a great burden will be placed on these tests. If the legislation is to be accepted, it will be necessary for the courts to meet this challenge by showing the flexibility to take full account of the types of arrangement being entered into using intermediaries, whilst giving concrete enough guidance to provide the commercial certainty needed by these arrangements and the new legislation. Some further statutory or extra-statutory guidance may also be needed, as discussed in Chapter 6 below.

22 **Chapter 4** considers the legislative response to particular types of worker for whom categorisation under existing case law is especially problematic. Workers in these ‘problem’ categories have grown in number over the last two decades and this development may continue. Examples are homeworkers, casual workers, agency workers and others supplying services through an intermediary, construction workers and entertainment workers.

23 There are various legislative approaches to dealing with cases where classification as employed or self-employed is difficult:

- a) the workers may be treated as if they were employees for some or all purposes, regardless of their status under the case law (for example, agency workers); the new personal service intermediaries legislation is a variant of this approach, discussed in Chapter 4;
- b) a group of workers may have a special procedure, such as deduction at source, or other set of rules, applied to them so that the question of employment status becomes less significant (for example, construction workers);
- c) a third approach, found in some modern employment legislation, is to bypass the concept of employee altogether and to extend provisions to ‘workers’, defined to cover all or some of those in the ‘grey area’.

24 All these techniques have their own advantages and disadvantages. New boundaries and definitions can be created, which bring their own definitional difficulties. Classification problems are not completely avoided, but they may be eased. Further specific legislation and subcategories are suggested by some as a solution to the problems of uncertainty and inadequacy perceived to result from our current case law classification. The existing special provisions examined in Chapter 4 provide some guidance to the effectiveness of these methods.

25 **Chapter 5** examines decision-making mechanisms for classification of workers for tax, National Insurance and employment law purposes. Considerable improvements have been made recently, with the merger of the Contributions Agency and the Inland Revenue. Both at an administrative level and within the court system, tax and National Insurance status decisions should be taken using a common approach, except where there are statutory differences.

26 There will continue to be differences between the approaches for tax and NICs purposes on the one hand and employment law on the other. Different courts again may consider employment status for other purposes, such as tort and contract. It would be impractical to draw all status decisions into one jurisdiction since the issue arises in so many different contexts. Courts do need to be clear, however, as suggested above, about which principles they are applying.

27 At an administrative level, for tax and NICs purposes, taxpayers need to be able to request binding opinions about status. The reluctance of the Inland Revenue to advise on hypothetical situations is understandable, but workers and their engagers do need to know in advance how workers will be treated for tax purposes in order to cost contracts and agree fees. Timely advice is also necessary. The personal service intermediaries legislation seems to have led to a greater willingness on the part of the Inland Revenue to give binding opinions within a time-limit. The handling of these opinions should be monitored. The system for those using intermediaries should be no more favourable than that for individuals supplying services directly. Time-limits could be considered for all status opinions.

28     **Chapter 6** poses some questions for further consideration arising directly from this paper. These relate to: judicial guidance on classification; the use of statutory extensions to cover particular groups of workers; ‘safe harbours’ to carve out certain groups of workers; the relationship between tax, National Insurance and employment protection; and the guidance to be given by the Inland Revenue and other government bodies on classification of workers. This chapter invites comments from readers.

29     The chapter goes on to outline some wider issues for future research on areas only touched on by this paper, such as National Insurance, cumulative PAYE, non-cumulative deduction at source and universal tax returns, and neutrality between legal vehicles for business.

30     The **Appendix** sets out some basic information about the differences in treatment between employed and self-employed in the areas of taxation (direct and indirect), National Insurance contributions and benefits, and employment rights and status, in order to elucidate points made in the body of the paper.

## **INTRODUCTION: CONTEXT AND PARAMETERS**

**The Tax Law Review Committee (TLRC) has been considering the issue of tax equity as between the employed and self-employed. This paper reflects part of the work undertaken at the request of the TLRC during its deliberations.**

**The questions addressed by the TLRC project have been broken down as follows:**

- Is it possible to make meaningful comparisons between the employed and self-employed or are these two groups too disparate for that to be a sensible exercise?**
- Is classification between employed and self-employed adequate to describe the different types of workers in the economy for tax purposes, or are different, or further, classifications needed?**
- If we are to retain an employed/self-employed divide, are the current case law tests sufficient? Would a statutory test be helpful?**
- To what extent, if at all, should tax and National Insurance classifications be concomitant with employment law categories?**
- What are the differences in taxation treatment and National Insurance contributions (NICs) between the employed and self-employed?**
- Can these tax and National Insurance differences be explained by reference to differences of substance between these two groups?**
- Could these tax and National Insurance differences be removed or reduced in a practical way?**
- What can we learn from the position in other jurisdictions? Are the problems experienced in the UK in any way unique or more extreme than similar problems elsewhere?**

**This paper looks primarily at the issue of classification. This is not because the other questions asked above are less important. Clearly, if tax and National Insurance differences between the groups of workers could be removed, classification would become less important for these purposes. The issues, however, need to be examined in stages. This particular paper is being published for discussion now because it is topical in the light of recent developments in the tax system and employment law. The paper should not be taken as stating any conclusions of the TLRC.**

## Background to the paper

0.1 In *Reforming the Personal Tax System*,<sup>1</sup> the Committee responsible for that Report 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 pay income tax just because one does so as a self-employed person while the other is employed?’

0.2 This statement reflects a widespread perception of unfairness about the relative tax treatment of the employed and the self-employed, current over many years and expressed by many committees and other bodies. This sense of unfairness centres not only on the differences in tax rules themselves but also on differences in implementation and enforcement of tax rules as between the self-employed and the employed.

0.3 The statement quoted in paragraph 0.1 needs to be submitted to thorough examination. First, the comment presupposes that individuals who are employed *can be* carrying on a ‘similar activity’ to those who are self-employed. Some would argue that, even where an employed and a self-employed person seem to be undertaking similar *tasks*, there is a fundamental difference in the nature of their *activities*. In other words, the classification of the person as either employed or self-employed arises from a genuine and fundamental difference, so that describing them as carrying on similar activities is inaccurate. This view, of course, assumes that the legal classifications are always based on real differences. Others would disagree, taking the view that whilst frequently the activities of the employed and the self-employed may be very different, it is possible for them to be carrying on similar activities. This is because, at the margins, the legal classification as employed or self-employed may not mark a fundamental distinction of substance. The extent to which the classification system really does mark some difference of substance between types of activity requires further consideration of the classifications of ‘employed’ and ‘self-employed’ and the way in which they are applied.

0.4 Second, the statement in paragraph 0.1 assumes that horizontal equity should be the guiding policy objective – that is, that individuals with similar levels of income should bear similar tax burdens. This supposes that it is possible to find comparable measures of income for employed and self-employed. Even assuming that this is so, horizontal equity is likely to be only one policy consideration. Some, including government, might say that other policy objectives (for example, correcting market failures or providing incentives for certain activities) or practical considerations might

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<sup>1</sup> (1993) Commentary no. 35, Institute for Fiscal Studies, London.

have to override horizontal equity in some situations. The statement therefore raises more complex questions than might at first appear.

0.5 The TLRC decided in 1996 to examine this topic in greater detail. The terms of reference that it set for this project were

‘To consider the differences in tax treatment between the employed and the self-employed and the extent to which tax liabilities of similarly placed individuals differed as a result.’

0.6 The tax differences that are the primary focus of discontent in this area in the UK are well known and centre mainly on the rules on deduction of expenses and taxation of benefits and on timing and method of collection of taxation. The general view is that the differences in the rules favour the self-employed, and this is broadly true, though there are circumstances in which the rules operate to the advantage of employees.<sup>2</sup>

0.7 The pure tax issues cannot be investigated sensibly in isolation. Differences in the NICs required of the employed and the self-employed are a central part of the question. As can be seen from the Appendix to this paper, the self-employed pay lower NICs than the employed, especially if the employer’s contribution as well as the employee’s is taken into account. To some extent, this can be explained in terms of the benefits to which the two groups are entitled, and this links to the contributory principle still said to underlie the National Insurance system. It is widely agreed, however, that the self-employed under-contribute to the National Insurance Fund, even allowing for their reduced entitlements.<sup>3</sup> Some would argue that this is simply recognition of other burdens on the self-employed, but the linkage is not straightforward.<sup>4</sup>

0.8 Additionally, the relationship with employment law is important in considering the tax issues of classification. It might seem that the tax and employment law classifications of employment status should be the same wherever possible, not least to reduce confusion and compliance costs, but further investigation raises questions about whether this is necessarily correct, given the different objectives of the two systems. Divergences may be desirable, but any divergence will create

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<sup>2</sup> For a more detailed discussion of these differences, see J. Freedman and E. Chamberlain, ‘Horizontal equity and the taxation of employed and self-employed workers’, (1997) *Fiscal Studies*, vol. 18, no. 1, pp. 87–118 (hereafter, Freedman and Chamberlain 1997) and the Appendix to this paper.

<sup>3</sup> Freedman and Chamberlain 1997 at p.102; *The Modernisation of Britain’s Tax and Benefit System, Number Two: Work Incentives: A Report by Martin Taylor*, (1998) HM Treasury, London (hereafter the Taylor Report 1998); L. Chennells and A. Dilnot (eds), *The IFS Green Budget: January 1999*, (1999) Commentary no. 76, Institute for Fiscal Studies, London (hereafter the IFS Green Budget 1999).

<sup>4</sup> See Appendix to this paper for further details.

particular difficulties in relation to NICs, which need to follow taxation if we see them as a form of taxation, but which may be seen as linked to benefits arising from employee status under employment law.<sup>5</sup>

0.9 Tax administration issues are of the utmost practical importance in recommending reforms. Here, as usual with taxation, a balance must be found between designing a system that is equitable in all its details and one that is cost-effective and practical to administer. For example, changes that would interfere with deduction at source under the PAYE system and the fact that the majority of employees in the UK do not complete a tax return might be unacceptable for administrative reasons.

0.10 In February 1997 an article arising from work undertaken on behalf of the TLRC was published, entitled ‘Horizontal equity and the taxation of employed and self-employed workers’.<sup>6</sup> This attempted to summarise the issues and problems surrounding the taxation of the self-employed and the employed in a structured way with a view to stimulating a focused debate. Some helpful comments were received and discussions held in the TLRC and with others. This paper continues one aspect of this debate: the issue of classification of workers as employed or self-employed for tax and NICs purposes.

### **Alignment of tax treatment of employed and self-employed**

0.11 One starting-point that has sometimes been suggested for reform would be to align all or some aspects of the tax treatment of the employed and self-employed. The argument is that reducing such differences would make determining whether someone is self-employed or employed – ‘the classification issue’ – less significant and therefore less problematic.

0.12 Reducing these differences is not simple. Major structural reform extending beyond the immediate issues being considered by the TLRC could be required. Change could bring with it new administrative difficulties and even new inequities, as well as solutions to existing problems.

0.13 One change that has been discussed by a number of organisations, most recently the Better Regulation Task Force,<sup>7</sup> is a full-scale merger of tax and NICs. Much of the motivation behind this pressure has been concern about compliance costs of running two different systems side by side. The cost of NICs collection, like PAYE,

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<sup>5</sup> For some relevant details on employment law, see Appendix to this paper.

<sup>6</sup> Freedman and Chamberlain 1997, fn. 2 above.

<sup>7</sup> The Better Regulation Task Force, *The Burden of Payroll Regulations, 2000* [www.cabinet-office.gov.uk/regulation/index/task.htm](http://www.cabinet-office.gov.uk/regulation/index/task.htm) (hereafter the Better Regulation Task Force 2000).

certainly adds to the burdens of taking on employees.<sup>8</sup> Merger of tax and NICs would not necessarily align the treatment of the employed and self-employed – they could still be charged different rates – but, in practice, treating NICs as a form of taxation would add force to arguments for alignment. It is largely the philosophy of the contributory principle which is relied upon to justify the higher NICs paid by and on behalf of employees than by the self-employed. In fact, the structure of NICs for the self-employed has begun to alter in recent Budgets, partly as a result of recommendations made by the Taylor Report.<sup>9</sup> Already, this has had the effect of significantly reducing the benefit to the self-employed from the NICs structure. Further changes, announced in the November 2000 Pre-Budget Report, have continued in this direction.<sup>10</sup>

0.14 In addition, the Contributions Agency has merged with the Inland Revenue and most NICs appeals are now heard by the Tax Appeal Commissioners. This has had an important impact on the issues under discussion.

0.15 Complete alignment of the tax and NICs systems, however, seems some way off. The Better Regulation Task Force<sup>11</sup> stated:

‘We understand that a full-scale merger of tax and National Insurance can only be a long-term goal as it involves major questions of both tax and social policy. In addition, there would be substantial systems implications for the Revenue and for employers. However we feel it is important that the Government is aware of the consensus in favour of such a merger amongst both the representative bodies and the individuals who contributed their views to our report. This takes us into areas of social policy and it is not our job to suggest how further integration might be achieved.’

0.16 The government has stated that it is not convinced that radical reform of the tax and NICs systems is the best way of delivering worthwhile simplifications for employers. In a discussion paper, it proposes instead changes of a more technical nature.<sup>12</sup> This has been criticised as inadequate. The Institute of Chartered Accountants of England and Wales has called for more root-and-branch reform, including a review of the contributory principle.<sup>13</sup> A representative of the Chartered Institute of Taxation commented:

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<sup>8</sup> Centre for Fiscal Studies, University of Bath, *The Tax Compliance Costs for Employers of PAYE and National Insurance in 1995–96*, (1998) Inland Revenue Economics Paper no. 3, Inland Revenue, London (hereafter the Bath Report).

<sup>9</sup> The Taylor Report 1998.

<sup>10</sup> See Appendix to this paper.

<sup>11</sup> The Better Regulation Task Force 2000, fn. 7 above.

<sup>12</sup> Inland Revenue, *Simplifying National Insurance Contributions for Employers*, (2000) Inland Revenue, London.

<sup>13</sup> ICAEW, 7 September 2000, TAXREP 28/00 [www.taxfac.co.uk](http://www.taxfac.co.uk).

‘There is only one prize worth winning in the race to simplify taxes on employees. That is the merging of tax and National Insurance Contributions ...’.<sup>14</sup>

0.17 There has been movement towards alignment of the tax and National Insurance systems, and the contributory principle has been losing its central role in social security policy over recent years.<sup>15</sup> It is important that further work on integration should be undertaken and discussion of this possibility should continue. There are, however, immense and deep-rooted political difficulties with radical change. The contributory principle remains an important one for many, even though it is being undermined in practice. In addition, both main political parties have undertaken not to increase income tax rates. This makes total integration in the near future seem unlikely, which suggests that other options also need to be explored.

0.18 Another area where alignment has often been proposed is in relation to the rules on computation of income for employees and the self-employed. The difference in the rules is sometimes blamed upon the schedular system in the UK. Some jurisdictions without a schedular system, however, also apply different rules to different types of income.<sup>16</sup> There *are* real differences between the gross income of archetypal self-employed activities, from which a profit figure has to be extracted in some way, and standard salary income. The true extent of these differences in different situations is discussed in the following chapters of this paper. Nevertheless, there are areas where some alignment of rules might be thought possible. For example, there is widespread support for a relaxation of the current strict rule for employees’ deductions of expenses, bringing it closer to that for the self-employed – for example, by removal of the requirement that deductible expenses be ‘necessary’.<sup>17</sup>

0.19 To align these rules for the two groups in this or other ways, however, might result in problems and complexities that could not be managed in practice within the current cumulative PAYE system of deduction at source. The strict rules for deductibility of expenditure by employees may be restrictive and sometimes seem

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<sup>14</sup> Anne Redston, Chartered Institute of Taxation Press Release, 5 September 2000, [2000] Simon’s Tax Intelligence (STI) 1377.

<sup>15</sup> IFS Green Budget 1999, fn. 3 above.

<sup>16</sup> A number of countries without a schedular system – Spain and Germany, for example – have different rules for deduction of expenses for employees and the self-employed; International Bureau of Fiscal Documentation, *European Tax Handbook*, (2000) IBFD, Amsterdam.

<sup>17</sup> By various bodies including: Codification Committee, *Report of the Committee on Codification of Income Tax Law*, (1936) Cmd 5131, HMSO, London; Radcliffe Committee, *Final Report of the Royal Commission on the Taxation of Profits and Income*, (1955) Cmd 9474, HMSO, London (hereafter the Radcliffe Committee), chapter 5; Institute of Taxation, *Representations on the Form and Administration of the Taxation System*, (1989) Institute of Taxation, London. (For a recent proposal, see R. Baron, *The Taxation of Employees and the Self-Employed*, (1998) Research Paper, Institute of Directors, London [hereafter IOD paper 1998].)

unfair but they have a simplifying result. Since almost no deductions are permitted, the need for year-end adjustments and communication between the taxpayer and Inland Revenue is reduced and, in many cases, eliminated. Only standard allowances for employees would fit easily into such a system. It can be seen that radical change in one area requires consideration to ensure that an improvement for some does not make tax more complex for many, or create such a level of compliance and administrative costs that the burden outweighs the benefits overall.

0.20 The cumulative PAYE system works well for taxpayers who have a clear employment status and work for one employer for a number of years. In cases of non-standard work, however – for example, casual workers – it has been suggested that cumulative PAYE is breaking down. In addition, cumulative PAYE imposes burdens on employers and is regressive in effect so that small businesses suffer the greatest burden.<sup>18</sup> Tax evasion by non-standard workers is also an issue that some argue should be tackled by more widespread deduction at source from non-standard workers.<sup>19</sup> Further work in this area is needed but, as with NICs, radical change would have major implications and is not likely in the near future. Again, this makes it important to consider the classification issue at this time, since alignment of the rules for all workers seems so difficult to achieve in practice.

### **Classification and the changing labour market**

0.21 One reason for these practical and other difficulties of alignment is that there is often, but not always, a fundamental structural and organisational difference between the self-employed and the employed. They may play different roles in the labour market, and risk allocation between them and the firm to which they are supplying services differs depending on their relationship.

0.22 Where these economic and social differences exist, arguably the employed and self-employed are *not* in comparable positions. They may be doing similar work and receiving similar financial benefits, but they are playing a different role in the labour market because of risk allocation and positioning in relation to the firm. This different role might make direct comparisons of their tax treatments inappropriate, even if superficially they seem to be in similar financial positions. At the very least, the tax comparison has to take account of these different economic roles, even if the conclusion is that the differences are insufficient to warrant different tax treatment.

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<sup>18</sup> The Better Regulation Task Force 2000, fn. 7 above, citing the Bath Report, fn. 8 above. See also report of the Select Committee on the Treasury (Sixth Report HC 199/1998/9).

<sup>19</sup> For example, see *Report of the Committee on Enforcement Powers of the Revenue Departments*, (1983) Cmnd 8822, HMSO, London (hereafter the Keith Report); but see Lord Grabiner QC, *The Informal Economy*, (2000) HM Treasury, London, at para. 4.10 of that paper, discussed below at para. 4.10.

0.23 To the extent that there are fundamental structural and economic differences between the self-employed and the employed, which are reflected in the method of classification for tax purposes, there may be no inequity in the different tax treatments accorded to each group. If, however, there can be differences in tax classification without any serious substantive difference existing in fact between some who are categorised as self-employed and some who are employees, then different tax treatments might well be inequitable and comparisons need to be made.

0.24 A sensible starting-point, therefore, is to examine whether the current method of classification between the self-employed and the employed for tax purposes is consistent and fair and to what extent it does indeed reflect real structural and economic differences in their positions. The current test is based primarily on case law drawn from many areas of law, though there are some statutory adjustments. Some would suggest further statutory intervention, whilst others consider the flexibility of case law to be helpful in changing circumstances. These issues are considered further in this paper.

0.25 Conditions and the nature of work are undergoing changes. At the margins, the distinction between the employed and self-employed was never entirely clear-cut, and now there are a growing number of workers occupying intermediate positions (or 'grey areas') between the two clear ends of the employed/self-employed spectrum. This has had consequences for employment law as well as for taxation, both of which are adapting in their own ways to meet the problem. Whether tax law is adapting sensibly is one of the questions discussed further in this paper. The question of the relationship between tax law and employment law and whether they can and should develop in tandem also requires discussion. There may be different policy objectives and practical considerations in the tax and employment fields. On the other hand, differences between classifications for these two purposes can cause cost and confusion for workers and employers and are particularly problematic in relation to NICs. Although NICs need to follow the tax classification for collection purposes, the payment of these NICs also relates to benefits in some cases, and in this sense NICs might be thought to be more closely related to employment status for labour law purposes. NICs straddle the two areas of tax and employment law, making divergence between the two problematic.

0.26 Employment legislation is moving away from the traditional methods of classification between the self-employed and the employed. In a research report published by the European Commission,<sup>20</sup> it is suggested that the nature of work is changing, away from the job whose prototype was manufacturing, to a new type of work, where the prototype is the service relationship. This new type of work requires new institutional forms and new ways of protecting workers.

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<sup>20</sup> European Commission D-G V, *Transformation of Labour and Future of Labour Law in Europe: Final Report*, (1999) CE-19-98-302-EN-C EUR-OP, Luxembourg.

0.27 This changing nature of work is leading to labour law developments throughout Europe and elsewhere. In the UK, recent legislation has given non-standard workers (not defined as employees under the case law) some of the same rights as employees in some circumstances.<sup>21</sup> The Employment Relations Act 1999 contains a wide power for government to extend existing employment rights to other workers.<sup>22</sup> In doing so, it follows the recommendations of a research report published by the DTI, which suggested that a move away from the employed/self-employed divide could both extend basic rights to persons requiring protection and reduce uncertainty in the operation of employment law.<sup>23</sup>

0.28 On the tax front, there have been fundamental changes in classification and collection in the construction industry, recognising that traditional case law tests of employment and self-employment are no longer sufficient to recognise the economic complexities. The structure and operation of these might give some guidance on how effective similar changes for other groups would be.<sup>24</sup> The tax system might attempt to identify each non-standard example and specify special treatment for such groups. Such multi-classification must be balanced, however, with administrative feasibility. On the other hand, multi-classification may be necessary if the tax system is to deal fairly with the complexities that exist as a matter of economic reality.

0.29 The legislation in the Finance Act 2000 dealing with personal service companies and other intermediaries, colloquially known as IR35, is another example of an attempt to adapt the tax system to meet changing work practices.<sup>25</sup> This legislation *deems* certain workers to receive Schedule E payments, even though the services of those workers are supplied through an intermediary company or partnership and payments are made to the worker by the intermediary in a way not subject to Schedule E taxation under normal rules.

0.30 In effect, the IR35 legislation seeks to ‘look through’ the intermediary arrangement in cases where the ‘real’ relationship is one of employment by the client, although the compliance burden and cost of PAYE and NICs payments is put onto the intermediary and not the client. Only tax law and NICs are affected: the legislation is careful not to deem the individual to be an employee and employment law remains unchanged. The critical test of the relationship used for IR35 tax purposes is the case law test for employment or self-employment. The original proposal was for a special statutory test based on control, but this was quickly rejected as inadequate. The contentious IR35 legislation therefore places a new burden on the case law on

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<sup>21</sup> For examples, see Chapter 4 below.

<sup>22</sup> Section 23.

<sup>23</sup> B. Burchill, S. Deakin and S. Honey, *The Employment Status of Individuals in Non-Standard Employment*, (1999) URN 98/943 no. 6, EMAR Employment Relations Research Series, DTI, London (hereafter the DTI employment status report).

<sup>24</sup> See Chapter 4 below.

<sup>25</sup> For more detail, see Chapter 4 below.

classification and has highlighted the problems of uncertainty created by this test based on the facts of each case.

0.31 The IR35 approach assumes that the ‘real relationship’ can be captured by a set of criteria that can be set out in case law and legislation. Although the original motivation for the change in law was to tackle the use of intermediaries set up purely for tax and NICs purposes, the resulting legislation risks going wider and covering arrangements that exist as a result of the economics and market practices of an industry and not purely for tax reasons. Due to the difficulty of distinguishing employees from the self-employed as described in Chapters 2 and 3, the legislation may catch workers who are attempting to create their own business but are at an early stage of this process. This has the curious result that the legislation could deter the very entrepreneurs the government seeks to encourage in other contexts.

0.32 The IR35 legislation has caused considerable disquiet amongst certain sectors of business (particularly the IT sector), industry and the tax professions. The reaction to it and the difficulty the Inland Revenue has encountered in producing sensible rules highlight the worker classification problem as well as other structural problems relating to the integration of corporate and personal taxation. IR35 is discussed further in the chapters below in the context of the classification test, although a full critique of the legislation is beyond the scope of this paper.<sup>26</sup>

0.33 One of the difficulties of the current tax system is that it is attempting to deal with a spectrum of workers. It is inevitable that the focus both of the Inland Revenue and of taxpayers will be on ‘hard cases’: those workers at the borderline of the employee/self-employed classification – the ‘grey area’. The vast majority of the working population, however, will fall clearly within one category or another. Any proposals for reform should not unsettle the position of the many for the sake of the few, nor should the classification rules be distorted in an attempt to deal with more fundamental structural problems of the tax system.

## **Objectives of this paper**

0.34 Radical reform, such as integration of tax and NICs or changes to the PAYE system, *might* be the only way to eliminate completely the problems of equity between the employed and self-employed. This paper does not address these issues further but this should not be taken as a comment one way or the other on the desirability of these reforms. Other issues of importance, such as methods of tax collection and differences in rules on computation, are also not addressed here.

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<sup>26</sup> The Professional Contractors Group has been granted leave to proceed with a judicial review on the basis that the personal intermediary provisions in the Welfare Reform and Pensions Act 1999 and the Finance Act 2000 are incompatible with EC law and the Human Rights Act 1998: decision of High Court 10/10/2000 (*Evening Standard*, 10/10/2000).

0.35 It is important that these issues continue to be discussed and researched. Whilst this wider work continues, however, the TLRC feels that publication of this discussion paper purely on classification issues is timely and helpful in the light of recent tax and employment law developments. This paper represents the thoughts and research of those working directly on the project. They do not necessarily reflect the views of the TLRC, which has discussed the issues and has authorised the publication of this paper to place the issues in a broader context and encourage informed debate.

0.36 Chapter 1 of this paper describes in more detail some of the problems encountered in trying to classify workers. Chapter 2 examines the evidence on changing work patterns and considers the implications of this for the legal rules on classification. Legal classifications are considered in detail in Chapter 3, which discusses the tests evolved in case law arising out of cases in many areas of law – primarily tax, National Insurance and labour law – and the relationship between them. Chapter 4 looks at legislative responses, both employment law and tax, to special cases where the case law has proved inadequate to deal with changing working practices. It examines the extent to which employment law has developed a different approach from tax law to classification and considers the arguments for consistency and separate development. Chapter 5 examines decision-making mechanisms for classification of workers for tax, National Insurance and labour law purposes. Finally, in Chapter 6, we sum up the main points arising from this paper and discuss some of the options for improving worker classification, as well as setting out some more fundamental questions for future research and consideration.

## **CHAPTER 1: THE PROBLEM OF CLASSIFICATION**

**Workers cover a broad spectrum. At each end of this spectrum, the features of the employed and self-employed can be clearly distinguished. The unequivocally self-employed person will be running a business on his own account, bearing the risk of loss, investing capital and independent of his clients. In a tax context, it would be impractical, if not impossible, to deduct tax at source from his gross income.**

**An unequivocally employed person in a long-term job will receive a wage or salary. He is more likely to be subject to some kind of direct supervision and will be integrated into the business to which he is supplying his services. It will be practical and convenient to require the employer to deduct tax at source from such an employee and a cumulative PAYE system will work well.**

**There are workers who do not fit either of these two descriptions precisely, but lie somewhere between the two ends of this spectrum. They may be described as occupying a ‘grey area’ at the borderline of the classification divide. Such workers may find themselves classified differently for different legal purposes.**

**Some differences in rules may operate unfairly even as between workers clearly and properly classified on one side or other of the divide. For example, some unequivocal employees will incur genuine expenses that they cannot deduct under the current rules. It is in relation to the group in the ‘grey area’, however, that the question of inequity between the employed and self-employed is most likely to be raised. This chapter examines the range of workers through the use of an example, in preparation for the discussion in Chapter 2 of changing work practices and in Chapter 3 of the classification process.**

1.1 As discussed in the introduction to this paper, if differences in treatment of different types of worker could be eliminated or reduced, classification would be reduced in importance. There are, however, practical difficulties in achieving this, as well as policy reasons against moves in this direction. A sensible alternative starting-point, therefore, is to examine whether the current method of classification for tax and legal purposes, which divides the employed from the self-employed, is fair and operated consistently and, as far as possible, in accordance with real economic differences between these groups of worker. If it is, differences in tax treatment may be justifiable to some extent.

1.2 Ideally, the classification system should be one that results in different tax liabilities being based on genuine distinctions and differences in income. In addition, the administrative systems used to decide and give guidance upon classification need to be clear and efficient, so that individual taxpayers, business and the Inland Revenue can operate them speedily and without unreasonable burden.

## Legal and other types of classification

1.3 This paper uses the term ‘economic classification’ to be distinct from ‘legal classification’. Lawyers, economists, sociologists and others use the terms ‘employed’ and ‘self-employed’ but not necessarily in exactly the same way or with the same connotations.

1.4 To the lawyer, the employed/self-employed divide represents a distinction that can have significant legal consequences. To assess the worker’s rights and liabilities, it is necessary to know clearly on which side of the line he falls. Subject to any special legislative provisions, this will be decided on the basis of the contractual rights and liabilities between the worker and the person or body to which he is supplying services. It is not purely a matter of the label or conditions agreed by the parties to the contract. Under UK case law, a court will assess the real nature of the relationship based on all the facts, but this will be the real nature of the relationship *in law*. Chapter 3 of this paper discusses in detail the way in which the courts approach this task. Courts look at a multitude of factors, and simply drafting a contract in one way or another will not put a worker on one side of the line or other. On the other hand, since ultimately the court must come down on one side or the other, slight contractual change (consistent with the actual relationship) can make a difference to status in borderline cases.

1.5 Within this legal scheme of things, all is black or white. There are difficult cases but no shades of grey. That this can over-simplify has been recognised by the law in some instances. For example, employment legislation increasingly uses the term ‘worker’, with a broad definition to extend employment rights to a wider class of person than employee.<sup>1</sup> There are tax and National Insurance provisions that deem certain taxpayers to be employees or treat them in some ways as if they were.<sup>2</sup> For legal purposes, however, even if additional categories are added or deeming provisions are used, ultimately lines must be drawn.

1.6 In practice, workers do not fall neatly within this binary classification but cover a broad spectrum. At each end of this spectrum, the features of the employed and self-employed can be clearly distinguished. At the extreme self-employed end, the worker will be running a business on his own account, investing capital, bearing the risk of loss and liability for his work and benefiting from the profits. He will contract to perform specified tasks rather than working for fixed hours. He will be independent and not integrated into the business organisations of his clients, of which there will be several. He may well have employees of his own. At the other end of the spectrum will be the employee, receiving a wage or salary, subject to some kind of direct

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<sup>1</sup> The main statutes conferring such rights are the Wages Act 1986, The National Minimum Wage Act 1998 and the Working Time Regulations 1998 and this category of workers afforded protection may be extended under the Employment Relations Act 1999.

<sup>2</sup> See Chapter 4 below.

supervision and integrated into the business to which he is supplying his services. Lawyers and economists are likely to agree without difficulty on these paradigm cases.

1.7 There are other workers, however, who do not fit either of these two descriptions precisely but lie somewhere between the two ends of this spectrum along a continuum. This group will exhibit a mixture of standard characteristics. Most commonly, they will supply labour only, but retain some degree of independence from the business organisation paying them. For legal purposes, often they must be classified on one or other side of the line even if they do not fit neatly. As a result, small differences in contractual arrangements may put them on one side of the legal employed/self-employed classification, even though they are carrying on a similar activity to another worker who has been placed on the other side.<sup>3</sup> It is possible that the resulting classification may not reflect their economic role in the firm as described below. We have called this group borderline or ‘grey area’ workers. They may need new legal classifications to fit them.<sup>4</sup>

1.8 Indeed, some new legal classifications are being developed. Workers who are not traditional employees but who have a high degree of economic dependence on one ‘employer’ as ‘employee-like’ are defined in German law (‘arbeitsnehmerähnliche Personen’) and also found in the UK concept of ‘workers’<sup>5</sup> and the Italian ‘parasubordinati’, which originated in a fiscal context.<sup>6</sup> A European Commission report has commented, however, that ‘both the German and Italian initiatives seem to leave plenty of room for improvement’ in terms of clarity and simplicity.<sup>7</sup>

1.9 Non-lawyers will often be less concerned than lawyers to make clear-cut classifications, although for some social science purposes, such as collection of statistics, it becomes important. Otherwise, classification will follow the particular purpose in hand and hybrid categories may be freely created. So, for example, labour or institutional economists might be concerned with the nature and organisational

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<sup>3</sup> This is recognised by the Inland Revenue in its Employment Status Manual, published in October 2000 on the Inland Revenue website, [www.inlandrevenue.gov.uk/manuals](http://www.inlandrevenue.gov.uk/manuals) – at ESM 0129.

<sup>4</sup> Note that a worker may be employed in relation to one engagement and self-employed in relation to another. In order to decide whether he is employed or self-employed, it will often be relevant to examine his engagements as a whole as described in Chapter 3 below, but he may have both kinds of status simultaneously, for all legal purposes.

<sup>5</sup> Chapter 4 below.

<sup>6</sup> P. Davies and M. Freedland, ‘Employees, workers and the autonomy of labour law’, (2000) in D. Simon and M. Weiss (eds), *Zur Autonomie des Individuums*, Nomos Verlagsgesellschaft, Baden-Baden (hereafter Davies and Freedland 2000); European Commission D-G V, *Transformation of Labour and Future of Labour Law in Europe: Final Report*, (1999) CE-19-98-302-EN-C EUR-OP, Luxembourg. Special provisions to combat ‘false self-employment’ have also been developed in Greece and Belgium: OECD, *Employment Outlook*, June 2000, p. 177.

<sup>7</sup> European Commission, fn. 6 above, at p. 5.

boundaries of the firm and the networks it creates. In this case, their main interest will be in the relationship of dependence or otherwise between the worker and the firm, his degree of integration into the firm and the way in which risk is allocated.<sup>8</sup>

1.10 The way in which firms organise their work has implications for the economy. Vertical disintegration by using workers external to the firm may create cost efficiencies, such as paying for workers only when needed. Equally, it may have disadvantages – for example, in terms of lost loyalty or knowledge – which bring their own costs. Decisions on these matters have an economic impact.<sup>9</sup> They result in different levels of risk allocation. In this sense, these different types of worker have different economic roles.

1.11 There is an obvious interaction between the economic classification of workers and their legal classification. In some senses, the legal tests are similar to the organisational interests of economists. To some degree, the relationship that economists are interested in is one created by law, since risk allocation and dependence will often be determined contractually. At each end of the spectrum there will be broad agreement, but at the border the economist may be content to accept that hybrid workers exist, whereas for legal purposes they must be placed on one side of the line or the other.

### **An example**

1.12 An example may assist.

- *A is a photographer employed by E, a newspaper. He works part-time – 15 hours per week – for a regular wage, with five weeks paid holiday, is entitled to sick pay and paid holidays, is a member of a pension scheme, has a company car and is entitled to one month's notice of termination of contract. He must attend E's offices, or anywhere else he is sent, and is directed on subject matter although not the detail of how to take the pictures. His equipment is provided. He needs permission to work for anyone else and may not substitute another worker for himself.*
- *B is a photographer. He has a contract with E under which he is paid by the hour. He provides his own equipment but takes pictures as and when directed in the same way as A and may not provide a substitute to do the work. In practice, he works 15 hours a week for E and for nobody else but he has no entitlement to be engaged for this number of hours. He is not entitled to any sick pay, holidays, pension or a car.*
- *C is a photographer who works for E as and when called upon at an hourly rate. He receives no other payments or benefits. He provides his own equipment and can*

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<sup>8</sup> See, for example, the more fluid and complex approach to classification in D. Marsden, *A Theory of Employment Systems*, (1999) OUP, Oxford.

<sup>9</sup> D. Marsden, fn. 8 above, at p. 40.

*send a substitute in his place but he or his substitute must take pictures as directed. He works for at least 10 other clients over a 12-month period although he customarily works 15 hours a week for E.*

In this example, A would be classified as an employee and C as self-employed. B is on the borderline. In practice, B seems to undertake almost identical activities to those of A, but he has no entitlement to regular work or pay and provides his own equipment. Changes to these conditions, which might make little or no difference in practice, could put B on one side of the line or the other for legal purposes. For example, giving B an entitlement to a minimum number of hours work would make B look more like an employee. The absence of this entitlement, or the ability to substitute another worker, would be a significant factor in making him self-employed. To an economist, B is probably a wage-labourer at this stage, regardless of his legal classification.

It is important to note, however, that B could be a budding entrepreneur, in the process of setting up the machinery to take on other work. This might be exactly the type of nascent small business that it is general government policy to encourage. Eventually and given the right conditions, B might take on staff himself. He might need to pay for machinery, business training or other expenses which could be non-deductible for tax purposes if he was an employee but deductible if self-employed. At the point described, his legal status would depend in part on the extent to which he was integrated into E's firm, in terms of his bureaucratic relationship with it. This might be difficult to assess purely from the legal conditions in the one contract with E, since it will also depend on the nature of other relationships, possibly established after the contract with E is entered into. Thus B's status as an employee or self-employed might not be something that could be assessed *ex ante*, but only with hindsight of the development of B's business. This can make it very difficult to know whether, for legal purposes, B should be compared with A or with C in terms of equality of treatment, even if we accept that A and C need to be treated differently for practical and conceptual reasons.

E calculates the payments to A, B and C on the basis that E receives a package of services that is similar from each but takes different risks in each case and provides equipment and other benefits for some and not others. In a perfect market and with perfect information, a price could be worked out for each that puts E in the same financial position regardless of which worker it uses and puts each worker in the same financial position (because risk is compensated for by higher pay). In practice, firms clearly do consider that there is a difference between these modes of delivery of services. They choose one arrangement over the other because they consider it to be more efficient. Factors such as loyalty, risk and maintaining knowledge levels may be difficult to value but may have important efficiency implications, so pushing the choice in one direction or another. The cost savings of not having employees (in terms of lower administration costs and fewer employment law liabilities) may not always be passed on in full to the worker.

In one sense, A, B and C are engaged in identical activity because they all take pictures on behalf of E. In theory, they could be paid equivalent compensation packages. This does not, however, put them in identical economic positions in the sense that A and C are playing different economic roles in the labour market. A is an employee, integrated into E's firm. C is running a business on his own account (whether or not he has employees). In economic terms, B might be described as a 'disguised wage-labourer' or a 'dependent self-employed' – a hybrid.<sup>10</sup>

This has implications for the way in which these taxpayers receive their income and for the taxation of that income. Even though they are all taking photographs, these three workers have different levels of integration into E's firm and bear different risks. C may be paid more than A to compensate for this risk – a 'risk premium'. Whether he is or not, a question arises in measuring the income of A and C and deciding whether what they receive is equivalent. Some account will need to be taken of C's additional expenses, which is relatively straightforward, but also of any risk premium paid to him. Is his income comparable to that of A? Are we comparing like with like?

A and C will need to be treated differently on a practical level. A receives a regular wage and benefits in kind. He has few, if any, expenses. He can easily have tax deducted at source by his employer under a system that requires no contact between him and the Inland Revenue, but any special allowance for expenses could compromise the feasibility of this process. C has payments from a number of clients and various overheads and other expenses and will not necessarily receive or be able to calculate his final profit until some time after he has earned it. Deduction at source from gross revenues would raise practical difficulties and it would only be possible to make estimated payments on account until profits for the period had been calculated. Inevitably, the year-end profit calculation will be more complex than that for A. C does not receive fringe benefits, which may be taxed more lightly than cash payments. It may be an over-simplification, therefore, to say that A and C are in comparable positions and that the income they derive from their activities is similar in all respects. This is not to say that comparisons cannot be made, nor, necessarily, that horizontal equity cannot be aimed at – merely that care has to be taken in any comparison of the two.

The position with B is more difficult yet. The question for tax purposes is whether he should be treated more akin to A or to C. In practice, since he has attributes of both, we might choose to apply a mixture of rules to him, but that could raise administrative difficulties. For example, deduction at source may work for him as he works for only one firm. Since, however, he takes a greater risk than A (in that in any one week there may not be 15 hours, or indeed any, work and has no entitlement to sick pay),<sup>11</sup> part of his pay is a 'risk premium' and part covers him for the fact that he receives no fringe

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<sup>10</sup> These terms are discussed further in Chapter 2 below.

<sup>11</sup> H. Collins, 'Employment rights of casual workers', (2000) 29 *Industrial Law Journal* 73 (hereafter Collins 2000).

benefits. In addition, he does have some expenses that it would seem unfair not to allow for tax purposes.

A, B and C also need to be classified for employment law and other legal purposes. Some of the relevant issues are similar to those that arise for tax purposes. There may also be different considerations in the case of employment law, especially in the case of B. For tax purposes, it is only necessary to classify B in respect of the work he actually undertakes for E, so that the parties to the contract know how to deal with payments made for that work. A further question that might arise in connection with employment law is whether B has any employment protection rights<sup>12</sup> should E not provide him with work at some point.

This example can become further complicated if it is decided on the facts that B is an employee in law, but he then sets up a company or other legal intermediary through which to supply his services to E. The IR35 legislation, referred to in the introduction to this paper,<sup>13</sup> seeks to ensure that he will not be able to use an intermediary to convert Schedule E income into corporate income, on which the tax and NICs would not be so great. This is on the basis that B is to be compared with, and treated equally to, an employee. This is, however, the critical question. Is this the fair comparison to make? In some cases it will be, but in others B will be in the course of setting up a business. Incorporation of a company as a vehicle may be one step in this process. It can be seen that it is extremely difficult to distinguish between a pure service provider who is essentially a wage-labourer and an entrepreneur at the beginning of the business building process. This is one basis for the current attacks on IR35.

## **Structural difficulties facing reform and issues for discussion**

1.13 This example illustrates the difficulty of comparing workers playing different economic roles and fitting them into legal classifications where those classifications result in different tax and other consequences. Many other variations could have been described.

1.14 The tax system could create an intermediate classification or attempt to identify each non-standard example and specify how each should be classified and dealt with.<sup>14</sup> It would be very difficult to provide in detail for all the possibilities and, in any event, such a multi-classification approach would have to be balanced with administrative feasibility. The more classifications there are, the more boundary lines there are to police and to increase uncertainty. On the other hand, multi-classifications may be necessary if the tax system is to deal fairly with the complexities that exist as a matter of economic reality.

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<sup>12</sup> For a brief description of some of these rights, see Appendix to this paper.

<sup>13</sup> And see Chapter 4 below.

<sup>14</sup> For examples of how some non-standard workers are treated by legislation and even extra-statutory concession, see Chapter 4 below.

1.15 One major tension is between certainty and the need to cater for the many varieties of working relationship, taking into account a range of factors. Some suggest that the current UK case law test is too uncertain and should be replaced by a more objective, statutory test. The problem is that objective tests, such as the number of clients served, can become arbitrary and offer opportunities for manipulation. Case law may also be *better* equipped than statute to remain flexible enough to meet changing working conditions, but the concomitant of that is that it will leave uncertainties, which can ultimately only be settled by litigation and which may well be expensive and time-consuming. This tension is discussed further in Chapter 3 below.

1.16 As discussed in the introduction above, these classification problems could be reduced by removing the differences in tax and NICs treatments between different groups. The above examples show that there are real differences at each end of the worker status spectrum, however, and it would be very difficult to remove all differences in treatment, though reduction of the differences might be possible.

1.17 While it is inevitable that the focus is on the ‘hard cases’, it must be remembered that the vast majority of the working population will fall clearly within the category either of employed or of self-employed. Any proposals for reform of classification issues must bear this in mind and must not unsettle the position of the many for the sake of the few.

1.18 The workers who may be most difficult to classify for legal purposes are those engaged in non-standard work. This is a relatively small but significant group that has expanded over recent years. The issue of changing work patterns and the role of these workers in the economy is discussed further in Chapter 2 below.

## CHAPTER 2: CHANGING WORK PATTERNS<sup>1</sup>

**Working patterns have changed significantly over the past 20 years. It is not clear how they will develop in the future. There are now more non-standard workers than previously: self-employed, part-timers and fixed-short-term workers. Not all these workers present problems for the tax system but some are at the borderline of the employed/self-employed classification. This classification was developed when employment patterns were generally more stable and straightforward. The increase in the number of non-standard workers therefore has implications for tax policy, and the characteristics of these workers require consideration when examining the adequacy of tax and other legal classifications of workers.**

2.1 Work patterns are changing. This is the result of a variety of factors, including the shift from manufacturing to services, technological advances, fragmentation of larger firms, economic cycles, levels of unemployment and government policies to promote an ‘enterprise culture’.<sup>2</sup> Self-employment has increased, as have various types of ‘flexible’ employment (part-time, temporary and fixed-term, homeworking and teleworking, for example).<sup>3</sup> The so-called ‘flexible work-force’ now constitutes about one-third of the total employed work-force, with the remaining two-thirds in permanent, full-time employment.<sup>4</sup>

2.2 The increases in self-employment and flexible employment have had an impact on the adequacy of legal definitions of different types of worker. As discussed in Chapter 1, legal classifications are generally based on a dual categorisation – a worker is employed or self-employed.<sup>5</sup> The economic and sociological reality is that a far greater number of categories than this is required to describe the variety of work patterns in widespread use in modern society. Hybrid descriptions can be used by social scientists in a way that is not practical for the purposes of taxation and

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<sup>1</sup> This chapter assumes that work as we know it will continue for the foreseeable future, in that we shall not see vastly increased leisure time for most people; on the relationship between work and leisure and the likelihood of work continuing in some form, see C. Handy, *The Age of Unreason*, (1989) Business Books Limited, London.

<sup>2</sup> J. Atkinson and D. Storey, ‘Small firms and employment’, (1993) in J. Atkinson and D. Storey (eds), *Employment, the Small Firm and the Labour Market*, Routledge, London, (hereafter Atkinson and Storey).

<sup>3</sup> C. Hakim, ‘Trends in the flexible workforce’, (1987) *Employment Gazette* 549 (hereafter Hakim).

<sup>4</sup> T. Lange and J. Atkinson, *Employment Trends and Prospects for Older Workers to 2030*, (1995) Institute for Employment Studies, Brighton; P. Gregg and J. Wadsworth, ‘A short history of labour turnover, job tenure and job security, 1975–93’, (1995) *Oxford Review of Economic Policy*, vol. 11, no. 1, p. 73 (hereafter Gregg and Wadsworth).

<sup>5</sup> The exceptions are discussed in Chapter 4 below.

employment protection. It is this mismatch between socio-economic reality and the legal classifications that creates many of the difficulties encountered in tax, National Insurance, employment law and other areas of law.

### **The self-employed**

2.3 The trend towards self-employment can be seen in most developed economies, but was particularly marked in the UK during the 1980s.<sup>6</sup> The level of self-employment in the UK rose from 1.9 million (7.5 per cent of the work-force) in 1979, to 3.3 million (12.2 per cent of the work-force) in 1990.<sup>7</sup> To some extent, however, this was a process of catching up with levels in other developed countries. Self-employment has been associated with high levels of unemployment, so we might expect economic growth to have led to lower levels of self-employment in the more recent past.<sup>8</sup> In the UK, the 1997/98 Labour Force Survey (LFS) estimate was that 3.2 million (12.4 per cent of the work-force) were self-employed.<sup>9</sup> So the rise has not continued, but neither has there been a fall.

2.4 During the period of increase in self-employment in the UK, there was a *decrease* in the proportion of self-employed who employed others – from 40 per cent in 1981 to 31 per cent by 1991.<sup>10</sup> The latest DTI figures show that, of 3.7 million businesses in existence in the UK in 1999, over 2.3 million (some 62 per cent) were made up of sole traders or partnerships without employees ('size class zero businesses').<sup>11</sup> The number of 'size class zero businesses' has fallen between 1997 and 1999, especially in agriculture, construction and the wholesale/retail sectors. In the construction sector, this may have been due to a move to employee status, coinciding with an Inland Revenue programme to impose correct tax classifications on construction workers.<sup>12</sup> An increase over the same period in the number of businesses with employees was mainly due to an increase in the number of single-employee companies (not classified as 'size class zero' even if the sole owner/director is the employee).<sup>13</sup> This development could also have tax reasons and may be reversed with the introduction of the new personal service intermediaries legislation. Despite these

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<sup>6</sup> OECD 1992, cited in Atkinson and Storey, fn. 2 above, at p. 12.

<sup>7</sup> M. Campbell and M. Daly, 'Self-employment into the 1990s', (1991) *Employment Gazette*, June, pp. 269–92.

<sup>8</sup> D. Storey, *Understanding the Small Business Sector*, (1994) Routledge, London (hereafter Storey 1994) at pp. 43–7 and 308.

<sup>9</sup> Figures cited in the DTI employment status report, fn. 23 Introduction above.

<sup>10</sup> Atkinson and Storey, fn. 2 above.

<sup>11</sup> SME Statistics Unit, *Small and Medium Enterprise Statistics for the United Kingdom*, 1999, (2000) URN 00/92 Government Statistical Service.

<sup>12</sup> See paras 4.22–4.24 below and note the signs discussed there that there may be a slight move back towards self-employment.

<sup>13</sup> SME Statistics Unit, *Small and Medium Enterprise Statistics for the United Kingdom*, 1998, (1999) URN 99/92, Government Statistical Service.

recent developments, however, a substantial majority of all UK businesses have no employees.

2.5 Clearly, much of the expansion of the self-employed sector during the 1980s was of people working on their own. Most, but not all, of these will have continued to work on their own rather than developing as entrepreneurs.<sup>14</sup> Others will have developed their businesses. These workers are classified as self-employed in the statistics broadly in line with legal classifications, although, since the LFS is based on self-reporting, there must be some doubt about borderline cases.<sup>15</sup> Many of these self-employed will fall within the category described above as the 'grey area'.<sup>16</sup> That is, if subjected to stringent legal analysis, some, or all, of their work might fall on the employed and self-employed borderline and probably onto the employee side of that border. In the small business literature, the self-employed without employees are frequently described as 'own-account workers'. Some who are very close to employees in characteristics are labelled 'disguised wage-labourers'.<sup>17</sup> Economists do not see self-employment as identical to the existence of a firm or business,<sup>18</sup> so that we 'cannot deduce merely from a rise in self-employment that there has been a rise in entrepreneurship, or in small businesses'.<sup>19</sup>

2.6 We have seen that at each end of the worker spectrum, the self-employed and employees play different economic roles. Risks are allocated differently as between them and the firms to which they are supplying their services. Integration into the operations of the firm, in terms of direction and bureaucratic organisation, also differ.<sup>20</sup> Some 'own-account' workers, even though correctly classified as self-employed under legal tests, are properly described in economic terms as 'disguised wage-labourers' or 'dependent self-employed'. This is because they are not, and do not seek to be, autonomous players in the labour process.<sup>21</sup> Others may be seen as

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<sup>14</sup> The evidence is that few firms grow and a minority of firms account for most job creation: Storey 1994, fn. 8 above, ch. 5.

<sup>15</sup> See the DTI employment status report, fn. 23 Introduction above. The LFS figures are one source used by the SME Statistics Unit in compiling its figures.

<sup>16</sup> See para. 1.7 above.

<sup>17</sup> H. Rainbird, 'The self-employed: small entrepreneurs or disguised wage labourers?', (1991) in A. Pollert (ed.), *Farewell to Flexibility?*, Blackwell, Oxford (hereafter Rainbird).

<sup>18</sup> D. Storey and S. Johnson, *Job Generation and Labour Market Change*, (1987) Macmillan Press, London, at p. 34.

<sup>19</sup> C. Crouch, *Social Change in Western Europe*, (1999) OUP, Oxford (hereafter Crouch), at p. 84.

<sup>20</sup> R.H. Coase, 'The nature of the firm (1937)', (1991) in O. Williamson and S. Winter (eds), *The Nature of the Firm: Origins, Evolution and Development*, OUP, Oxford; H. Demetz, 'The theory of the firm revisited', in Williamson and Winter, *ibid.*; H. Collins, 'Independent contractors and the challenge of vertical disintegration to employment protection laws', (1990) 10 *Oxford Journal of Legal Studies* 353 (hereafter Collins 1990).

<sup>21</sup> Rainbird, fn. 17 above; M. Harvey, *Towards the Insecurity Society: The Tax Trap of Self-Employment*, (1995) Institute of Employment Rights, London (hereafter Harvey); the DTI employment status report, fn. 23 Introduction above.

‘apprentice’ employers with independent businesses. Although these latter workers do not have employees initially, they may have a level of autonomy and business organisation or they may develop this and take on employees in the future.

2.7 It is not unique to the UK that a high proportion of the increase in self-employment in the 1980s and 1990s was accounted for by ‘own-account’ workers. This is a phenomenon noted across developed economies and often arises from government policies designed to encourage self-employment, particularly amongst unemployed people. This inevitably results in the development of self-employed businesses with relatively low levels of resources. Governments then become concerned about the fact that these ‘own-account’ workers are being classified as self-employed for tax and social security purposes. Work situations that are classed as self-employment primarily in order to reduce tax liabilities are now entitled ‘false self-employment’ by the OECD, and many governments have taken action to combat this so-called false self-employment by introducing legislation to reclassify these workers as employees.<sup>22</sup> Yet, as we shall see,<sup>23</sup> this mixture of incentives, coupled with provisions to prevent certain persons from using them, can create confusion. This approach is not logical in a situation where an ‘own-account’ worker can develop into an entrepreneur, given the right conditions.

2.8 Research undertaken to reveal the nature of the working arrangements under which those who classify themselves as self-employed actually operate listed a number of factors to determine ‘autonomy versus dependency’.<sup>24</sup> The responses did not usually reveal a straight row of negatives or affirmatives. Thus a simple twofold classification of the self-employed into ‘genuine’ and ‘pseudo’ versions has to be rejected as over-simplistic. Instead, the research shows that, for the purposes of describing the various existing arrangements accurately, the self-employed should be dotted along a continuum separating the two extremes. In other words, they cover a wide range of working arrangements with no straightforward division between different groupings.<sup>25</sup>

2.9 Much effort has been invested by small business researchers in distinguishing the characteristics of the ‘entrepreneur’ from those of the self-employed person who

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<sup>22</sup> OECD, *Employment Outlook*, June 2000, at p. 177; Davies and Freedland 2000, fn. 6 Chapter 1 above; paras 3.11 and 3.12 below.

<sup>23</sup> In the following discussion, and note the personal service intermediaries legislation, discussed in Chapter 4 below, as a case study.

<sup>24</sup> B. Burchell and J. Rubery, ‘Categorising self-employment: some evidence from the Social Change and Economic Life Initiative in the UK’, (1992) in A. Felstead and P. Leighton (eds), *The New Entrepreneurs: Self Employment and Small Business in Europe*, Kogan Page, London; A. Felstead and P. Leighton, ‘Issues, themes and reflections on the “enterprise culture”’, (1992) in Felstead and Leighton, *ibid.*

<sup>25</sup> This is borne out by the results in the DTI employment status report, fn. 23 Introduction above. These results show that the various tests of dependency do not always point in the same direction – see table 4.2.

will always be a dependent provider of personal services only. Conclusive spotting of entrepreneurs is, however, difficult. Storey has carried out an extensive review of research on defining the characteristics of growth firms. He identifies the three factors needed for growth of a firm as being

- the background/resources of the entrepreneur,
- the nature of the firm itself (e.g. age and sector) and
- the strategic decisions taken by the owner manager.

He is forced to conclude, however, that it is very difficult to judge at start-up whether these factors are present.<sup>26</sup> Someone who looks like a ‘disguised wage-labourer’ may turn out to be an entrepreneur.

2.10 This evidence from the small business literature has implications for tax policy. The problem is that, as discussed in Chapter 1, unless all are to be treated in exactly the same way, which is not always possible as between those clearly self-employed and those who are clearly employees, tax and other areas of law must draw a definite line between these categories. There will be significant consequences, depending upon which side of this line a worker falls. This fits uncomfortably with what has been described as ‘a myriad of patterns of the allocation of contractual risk and the degrees and range of bureaucratic controls’.<sup>27</sup> It is very difficult to fine-tune tax policy, which has to be based on a crude binary classification, to deliver sensible results over this wide range of work arrangements.

2.11 For example, governments often wish to offer tax and National Insurance ‘incentives’ to entrepreneurs who set up their own businesses.<sup>28</sup> If such incentives are directed generally to all the self-employed, there will be an incentive for taxpayers who are closer to the dependency end of the continuum to ensure their affairs and relationships are agreed in such a way that they are treated as self-employed under the case law. It will be very difficult to devise legislation that distinguishes between these workers within the self-employed ‘band’ of the continuum, even though they are at different ends of it. Any structural difference in the tax system which is not a deliberate ‘incentive’, but which appears to favour the self-employed over employees, will offer a similar inducement. This is an inevitable reaction to the existence of tax differences. However carefully the line between employees and the self-employed is drawn for tax or other legal purposes, the range of those quite correctly classified as

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<sup>26</sup> Storey 1994, fn. 8 above, at p. 158.

<sup>27</sup> Collins 1990, fn. 20 above.

<sup>28</sup> Business owners and their representatives sometimes claim that these incentives merely bring them into line with others who do not have to bear the burdens and costs of running a business. This again raises the question, discussed in Chapter 1, of whether we can say we are comparing like incomes with like. Nevertheless, the word ‘incentive’ has been used here because this is the way government often describes its objectives.

self-employed will cover a variety of working patterns with different economic consequences.<sup>29</sup>

2.12 The research outlined above shows how difficult it is to draw a line between the entrepreneurial self-employed at one end of the entrepreneurial continuum and the dependent self-employed at the other. This is so because individuals move along this continuum and because the relevant characteristics cover a range, so that the overall picture is not black and white. In the DTI employment status report, the authors suggest that the key characteristics of ‘genuine self-employment’ are

- working for a large number of clients<sup>30</sup> and
- having employees and/or the ability to hire others to work in substitution for themselves.

These are good guides if they are present, but their absence does not necessarily mean that a worker is not running a business on his own account, or attempting to do so.

2.13 A person starting out at the end closest to dependence *may* develop his business. Indeed, government policy is to promote such growth. An attempt to tailor tax policy to the self-employed with the above characteristics could backfire because it would not take into account nuances and shades of grey, nor the dynamic nature of businesses. Thus, limiting a tax incentive to the self-employed with employees *could* encourage the self-employed to take on employees, but only if they had reached the stage where this was economically feasible. Such a limitation of relief could also inhibit a self-employed person without employees from making the investment needed to promote the business and generally could reduce his ability to grow and be profitable. It would not enable the sole service provider to operate on a level playing field with other larger businesses. A worker who was once an employee may continue to provide services mainly for his old employer when he first starts up. He may also be putting into place a business organisation and beginning to take on work from others in a bid to expand his client base, at the same time. It will be difficult to judge at this stage whether he will succeed in this endeavour, but if he is not treated for tax

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<sup>29</sup> A similar result will ensue if government seeks to favour one legal form over another through tax reliefs or allowances. The 10 per cent rate of tax for companies introduced in 1999 is an example of a relief introduced to encourage entrepreneurs using one business form. This might attract those whom government does not consider to be ‘genuine entrepreneurs’ to incorporate, leading to ‘anti-avoidance legislation’ – see paras 4.81–4.84 below.

<sup>30</sup> This statement was based on a quantitative survey that questioned how many organisations/agencies the worker had worked for in the last six months, followed up in some cases by individual interviews asking ‘how many people do you work for?’.

purposes as running his own business, he may be unable to take the next step towards entrepreneurial endeavour.<sup>31</sup>

2.14 On the other hand, some self-employed may always remain closer to employees economically and have no intention of doing otherwise. Treating these workers differently from employees also appears to create a tax distortion. It is these workers who will often give rise to charges of anomalies and perceived injustice. Whilst economists and sociologists can describe a complex scenario in terms of a continuum, for legal purposes a line must be drawn somewhere and there will always be people close to the borders. Any attempt to deal with anomalies at one border can have an impact further along the continuum and create new anomalies there. It is important to recognise the needs relating to firms at both ends of the continuum when devising legal tests.

2.15 Not all self-employed workers choose to be classified as self-employed for tax or other purposes. The position is much more complex than this. It may also involve choices by the firms to which services are being provided and industry practice in different sectors. In some industries, often where workers are lower paid and vulnerable – for example, book publishing, hotel and catering, construction and milk delivery workers – there is empirical evidence that workers may be given little choice about employment status if they want to find work at all.<sup>32</sup> In other industries, where workers are higher paid, the customary mode of organisation may be to outsource work that requires specialist skills that may not be needed in the long term. Examples here are the oil and IT industries. This may suit the workers in some cases<sup>33</sup> but its origin may be in the organisation of these industries and their vertical disintegration rather than in the tax system.<sup>34</sup>

2.16 In broad general terms, the higher-paid often will benefit financially from classification as self-employed for tax and National Insurance purposes.<sup>35</sup> The loss of employment protection may not be a major problem for them because they have

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<sup>31</sup> It is possible also that he might be spurred on by the tax differences to take a further step to independent activity, but he will only be able to do this if the economic circumstances are right – it may not always be a matter of choice.

<sup>32</sup> Harvey, fn. 21 above (construction industry); C. and J. Stanworth, 'Reluctant entrepreneurs and their clients: the case of self-employed freelance workers in the British book publishing industry', (1997) *International Small Business Journal*, vol. 16, no. 1, p. 58; E. Boyle, 'The rise of the reluctant entrepreneurs', (1994) *International Small Business Journal*, vol. 12, no. 2, p. 63 (dairies laying off milkmen and requiring them to become 'franchisees').

<sup>33</sup> As seen from the DTI employment status report figures in para. 2.18 below.

<sup>34</sup> J. Burton, *Inflexible Friend: The New Flexible Economy and Professional Services*, (1999) Adam Smith Institute, London, ch. 3.

<sup>35</sup> See Appendix to this paper.

highly marketable skills and can afford to insure against various risks.<sup>36</sup> There are exceptions to this, particularly in the case of older workers who may lose pension rights if laid off late in their careers.<sup>37</sup> But the lower-paid are more likely to lose out financially and in employment protection terms from self-employed classification. The firms being supplied with the services may gain financially, whether the workers are lower- or higher-paid. Not only will they save tax and National Insurance payments and administration, but they will have greater flexibility in taking on and laying off staff. If others in the industry are using mainly free-lance workers and not treating them as employees, then firms may feel pressure to adopt this strategy themselves in order to remain competitive. Some of the savings may have to be passed on to workers by way of higher pay, but not all will be, especially where there are total savings of costs for both parties. On the other hand, firms may wish to retain skilled workers by employing them permanently, especially where they have invested in their training or where the workers have acquired information about the firm that would be of value to competitors.<sup>38</sup>

2.17 Interviews with employers/clients have shown that the single most important reason firms give for using self-employed people is the provision of specialist skills. In responses to an Employment Department survey, 60 per cent of employers surveyed stated that they used self-employed workers to provide specialist skills, 29 per cent to match manning levels to peaks in demand, 28 per cent because workers preferred to be self-employed, 6 per cent to reduce non-wage costs such as pensions and sick pay, and 3 per cent to avoid responsibility for PAYE and NICs. It is possible that tax and cost reasons were under-reported, but even so the difference in these figures is very large.<sup>39</sup> Whilst tax and other savings are a factor, therefore, there are also strong commercial reasons for the organisation of business using self-employed labour.

2.18 The DTI employment status report<sup>40</sup> asked respondents whose employment status was ambiguous (defined as self-employed without employees, those in temporary work and those working under some sort of non-standard working arrangement) why they worked as they did. Overall, 64 per cent of this group said that this was due to their own preference, but 30 per cent said that it was due to their employer's or client's preference or the only basis on which work was available. The

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<sup>36</sup> The loss of employment rights (e.g. the right not to be unfairly dismissed) is not trivial, however, especially now that the compensation limit has been lifted to £50,000 (see Appendix to this paper). Contractual rights may, of course, be much higher.

<sup>37</sup> Women, even higher-paid women, may also prefer employment if maternity leave might become an issue, and other rights and loss of the opportunity to participate in share option and profit schemes might also be a consideration.

<sup>38</sup> See the scenarios described in Future Unit, *Work in the Knowledge-Driven Economy*, (1999) DTI (hereafter Future Unit).

<sup>39</sup> A. McGregor and A. Sproull, 'Employers and the flexible workforce', (1992) *Employment Gazette*, May, p. 225 (hereafter McGregor and Sproull); D. Wood and P. Smith, *Employers' Labour Use Strategies*, (1988) Research Paper no. 63, Department of Employment.

<sup>40</sup> Fn. 23 Introduction above.

rest of the respondents gave some other reason or did not know. The DTI employment status report does not specify reasons for these preferences, but there may be many reasons, in addition to taxation and NICs, for a person to prefer self-employment despite the loss of benefits: for example, flexibility as regards hours worked and the type of work undertaken.

2.19 Views differ about the structure of work in the future, especially in the light of technological change. Some believe that self-employment will continue to grow, with business networks replacing management hierarchies. Others argue that employment patterns have now stabilised and that it will be in the interests of business to capture and internalise the new knowledge and technological skills. Based on these different approaches in the literature, the DTI Future Unit<sup>41</sup> has devised two scenarios. In the first, ‘Wired World’, self-employment and portfolio working<sup>42</sup> are common and small businesses have become the dominant force in the economy. In the second, ‘Built to Last’, stable and often large companies seek to capture knowledge to gain a competitive advantage, by offering comprehensive remuneration packages so that self-employment and temporary contract work are rare.

2.20 In the light of uncertainty about which of these views of work will be closer to reality, the Future Unit recommends that government officials should test the robustness of decisions against both scenarios. It is clearly difficult to tailor a tax system for both of these very different possibilities, but it seems essential to bear them in mind when planning reforms. As we have seen, the problems are not unique to the UK and changing work patterns are causing many other countries to examine their tax, social security and employment law provisions and to introduce special rules for non-standard workers.<sup>43</sup>

2.21 The current position is that there is a sizeable percentage of the work-force operating as self-employed with no employees. Such workers may or may not properly be described as running a business in economic terms, and some of those who start as being closer to employees may develop a business, whilst others may not. The differences are multi-factored and not susceptible to a simple test. The size of the group has increased substantially since 1980 and poses the tax system with issues it was not designed to meet. There is at least a possibility that the number of taxpayers falling within this group will increase in the future, and the robustness of the design of the tax system needs to be measured against this possibility.

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<sup>41</sup> Future Unit, fn. 38 above.

<sup>42</sup> ‘The portfolio is a collection of different bits and pieces for different clients. The word “job” now means a client’: C. Handy, *The Empty Raincoat: Making Sense of the Future*, (1994) Hutchinson, London.

<sup>43</sup> See OECD, *Employment Outlook*, 1992 and 2000.

## Part-timers and temporary workers

2.22 Temporary and part-time workers probably offer greater classification difficulties for employment law purposes than for tax and National Insurance. It is often clear that such workers are employees for tax purposes. What matters for tax is the relationship in existence at the time and not whether there is a mutual obligation relating to provision of work and the undertaking of it in future – a very important factor in employment law cases.<sup>44</sup> In addition, there are special legislative tax provisions, in particular those relating to agency workers, which do not apply to employment protection law. Nevertheless, there are important associated tax and National Insurance contribution problems with short-term and multiple employments in a system of cumulative PAYE, which works best where there is stable long-term employment. Thus the increase in portfolio, ‘casual’ and temporary working does have implications for the administration of the tax system.

2.23 The nature of the ‘flexible work-force’ has been the subject of considerable recent controversy. It has been argued that the work-force has been dividing into two sections – the *core* and the *periphery*.<sup>45</sup> The core workers have better working conditions than the periphery, working under non-standard contracts – that is, temporary, part-time and the ‘dependent self-employed’. There is disagreement as to how far this is the result of deliberate employer strategy,<sup>46</sup> how much a question of worker preferences<sup>47</sup> and how much simply a reaction to economic conditions, although it is clear that non-standard workers are often disadvantaged in terms of employment conditions.<sup>48</sup>

2.24 The size and growth of the periphery is also at issue, partly due to definitional problems and reliance on self-reporting surveys. Hakim showed that, in 1981, full-

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<sup>44</sup> On the mutuality of obligation test, see Chapter 3 below and the DTI employment status report, fn. 23 Introduction above.

<sup>45</sup> This thesis was originally that of J. Atkinson, ‘Flexibility or fragmentation? The United Kingdom labour market in the eighties’, (1987) *Labour and Society*, vol. 12, no. 1, January, and see D. Gallie, M. White, Y. Cheung and M. Tomlinson, *Restructuring the Employment Relationship*, (1998) Clarendon Press, Oxford (hereafter Gallie et al.) and the research discussed there.

<sup>46</sup> See McGregor and Sproull, fn. 39 above

<sup>47</sup> Hakim, fn. 3 above.

<sup>48</sup> Gallie et al., fn. 45 above, although they point out (in chapter 6) that different employment conditions are associated with different types of non-standard work making the core/periphery analysis misleading. For example, part-time workers, in their view, are no more insecure than full-timers, but short-term temporary workers, not surprisingly, feel their jobs are highly insecure. Non-standard workers will often not benefit from benefits such as participation in pension or share option schemes and this means that they cannot participate in tax reliefs available to others. They may also find it difficult to build up National Insurance contribution records to entitle them to receive benefits, even though they do pay contributions when in employment.

time regular employees made up 70 per cent of those in the work-force.<sup>49</sup> By 1986, this had dropped to 65 per cent, so she identified one-third of the work-force as ‘flexible’, although there are problems of definition. Figures for 1993, based on the General Household Survey and the Labour Force Survey, show around 50 per cent of the population of working age (note the different definition) in full-time employment, with nearly 15 per cent in part-time employment. The remaining members of this population are in self-employment, temporary employment, government schemes, unemployed or inactive within the labour market.<sup>50</sup> The increase in part-time employment is heavily linked to the increasing proportion of women in the work-force.<sup>51</sup>

2.25 These figures may exaggerate the level of job insecurity in the UK.<sup>52</sup> For the majority (the core), job tenure and security have not changed greatly. The data suggest, however, that for those on the periphery, the labour market is dominated by part-time and temporary jobs.<sup>53</sup> While full-time permanent posts for employees have almost certainly not become more unstable, the labour market now contains more unstable forms of employment than ever before. For workers falling within the less stable, peripheral group, there may be little option of obtaining a full-time job. For example, only 40 per cent of all posts filled by those out of work are full-time and permanent, and exit from the ‘flexible’ employment forms usually ends in complete exit from the employed labour force. These are the most vulnerable members of the work-force. If their employment status is in doubt for legal and tax purposes, or the administrative systems are not designed to deal with them, they are put into an even more difficult position.<sup>54</sup>

## Homeworkers and teleworkers

2.26 People working *at home*<sup>55</sup> (homeworkers) present a particular challenge in terms of worker status classification. Some are classified as employees, some as self-

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<sup>49</sup> Hakim, fn. 3 above.

<sup>50</sup> Gregg and Wadsworth, fn. 4 above.

<sup>51</sup> Gallie et al., fn. 45 above.

<sup>52</sup> S. Burgess and H. Rees, ‘Lifetime jobs and transient jobs: job tenure in Britain 1975–1991’, Bristol University Economics Department Working Paper, cited in Gregg and Wadsworth, fn. 4 above.

<sup>53</sup> Gregg and Wadsworth, fn. 4 above, using data from the General Household Survey and the Labour Force Survey; Crouch, fn. 19 above, at p. 80.

<sup>54</sup> The Ins and Outs sub-group of the Low Incomes Tax Reform Group focuses on the administrative issues faced by those moving into and out of employment, self-employment and unemployment: for a report on its activities, see *Taxation Practitioner*, October 1999.

<sup>55</sup> Contrast people working *from* home, such as plumbers or builders who advertise their home numbers but travel elsewhere to do the work – these people are excluded from Census and LFS figures on homeworking – see A. Felstead and N. Jewson with J. Goodwin, *Homeworkers in Britain*, (1996) DTI/DfEE Research Studies RS1P, HMSO, London (hereafter Felstead et al. 1996).

employed. They often have mixed characteristics. Their home base suggests that they will have at least some expenses that an employee would not normally have, such as rent, heating and lighting. Often, but not always, they will provide their own equipment. This has clear tax implications. On examination, however, such workers are sometimes very dependent on one supplier of work, and the level of control exercised over their work may be significant. In relation to employment law, mutual obligation to work and provide work may be a difficult issue.

2.27 As a result of these special problems, specific legislative provisions within employment law have protected homeworkers.<sup>56</sup> These special provisions do not extend to tax and National Insurance. For these purposes, as a result of the many factors pointing in different directions, homeworkers are often at the borderline of employee and self-employed.<sup>57</sup> Others are clearly employees, but because they are working in a way not envisaged when the tax rules on expenses, for example, were evolved, they are not catered for effectively by the current system.<sup>58</sup>

2.28 ‘Traditional’ homeworkers, such as workers in the clothing industry and those engaged in packaging and routine clerical work, are often extremely vulnerable in that they may be unskilled and/or have little bargaining power. These workers must be distinguished from a new breed of workers working in their own home – the teleworkers and IT workers who have been encouraged by the new technology to new patterns of working, who may well be higher-earning and have a greater choice about their working conditions. But the position must not be over-simplified. There are not just two forms of homeworking. Work at home can take many forms and cover many types of activity, from well-paid consultancies through free-lance publishing and clerical work to low-paid child-minding and manufacturing and packing.<sup>59</sup>

2.29 Figures on homeworkers are unclear, not least because of definitional problems.<sup>60</sup> Working from LFS figures, Felstead showed a tripling of homeworkers from 100,000 in 1981 to 250,000 (plus 55,000 whose second job was homeworking) in 1994. He found that four out of every five homeworkers were women. Of homeworkers, 70 per cent of males and 42 per cent of females classified themselves as self-employed.<sup>61</sup> There may be serious under-reporting of homeworking, however,

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<sup>56</sup> See Chapter 4 below.

<sup>57</sup> See Chapter 3 below for a case where a homemaker was classified in different ways for different legal purposes.

<sup>58</sup> See para. 2.32 below.

<sup>59</sup> C. Stanworth, *Working at Home: A Study of Homeworking and Teleworking*, (1996) Institute of Employment Rights, London (hereafter Stanworth 1996).

<sup>60</sup> A. Felstead and N. Jewson, *In Work, At Home: Towards an Understanding of Homeworking*, (1999) Routledge, London (hereafter Felstead and Jewson 1999). There are also many methodological problems discussed in this book.

<sup>61</sup> A. Felstead, ‘Concepts, definitions and estimates of the extent and characteristics of homeworking in Britain’, (1995) paper presented to the 17<sup>th</sup> International Working Party on

particularly amongst inner-city residents and ethnic minorities.<sup>62</sup> The National Group on Homeworking estimated that there were significantly higher numbers of homeworkers than Felstead's research showed: over a million in 1994.<sup>63</sup> In its study, two-thirds of the sample were in the fashion trades, with others doing assembly work and envelope-stuffing. Only about one-third of these homeworkers were regarded as employees, although many would have preferred this status. Pay was very low.<sup>64</sup>

2.30 In subsequent work for the Employment Department, Felstead and his colleagues used 1991 Census figures. These showed that 5 per cent (1,162,810) of the work-force in Great Britain 'works mainly at home'.<sup>65</sup> According to the 1997/98 LFS, only 2.4 per cent of the work-force is homeworking.<sup>66</sup> Both these surveys involve self-reporting but the Census includes people who work in the same grounds and buildings as home, such as hotel workers, who would be excluded from the LFS. This may explain the discrepancy.<sup>67</sup> There may be similar under-reporting of certain groups for both surveys.

2.31 The study of homeworkers by Felstead and his team for the Employment Department expressly targeted a sample of homeworkers from the manufacturing sector and lower-status service sector and so was not representative of homeworkers nationally.<sup>68</sup> It also used a narrow definition of homeworkers. Of this sample, 91 per cent was female and 54 per cent of ethnic minority origin. Sewing was the most prominent form of activity.

2.32 One-third of this particularly vulnerable group regarded themselves as self-employed and responsible for their own tax and NICs, but 45 per cent of the sample as a whole had only ever worked for one supplier of work. Fifteen per cent felt unable to describe their employment status. Nine out of ten of the total sample had no written contract outlining the terms and conditions of their employment. Sixty-eight per cent preferred working at home to working in a factory or office, mainly so that they could fulfil childcare commitments, but only one-quarter stated that they preferred to be self-employed. Only one-third of the self-reporting 'self-employed' group claimed expenses against tax, despite the fact that over 70 per cent of the sample as a whole said they incurred financial costs on lighting and heating. Some also incurred expenses on work materials, purchase of machines, telephone calls and travel.

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labour market segmentation Conference, University of Sienna, July (cited in Stanworth 1996, fn. 59 above).

<sup>62</sup> Felstead et al. 1996, fn. 55 above.

<sup>63</sup> U. Huws, *Key Results from a National Survey of Homeworkers*, National Group on Homeworking, Report no. 2, discussed in Stanworth 1996, fn. 59 above.

<sup>64</sup> This was before the introduction of the Minimum Wage Act which now (in theory at least) protects many homeworkers – see Chapter 4 below.

<sup>65</sup> Felstead et al. 1996, fn. 55 above.

<sup>66</sup> As reported in the DTI employment status report, fn. 23 Introduction above.

<sup>67</sup> Felstead et al. 1996, fn. 55 above, at para. 3.6.

<sup>68</sup> The following figures are all from Felstead et al. 1996, fn. 55 above.

2.33 Felstead and Jewson's latest figures<sup>69</sup> for the UK suggest that the numbers working *mainly at home* doubled from 1.5 per cent in 1981 to 2.5 per cent in 1998. He records that figures for 1998 suggest that those *partially working from home* account for 3.5 per cent of the employed work-force, while those reporting working some time at home account for another 21.8 per cent. In total, therefore, almost 28 per cent of the UK work-force carry out some of their work at home. Average pay is higher for those working at home than for those working elsewhere, but this overall figure conceals the low pay of manual homeworkers. Homeworking is also increasing elsewhere in Europe and in the US, Australia and Canada.

2.34 It can be concluded that homeworking is increasing. Those working at home can have a great variety of activities and conditions. Amongst the most vulnerable 'traditional' homeworkers, as investigated in Felstead's team's 1996 study, there is some uncertainty about employment status and therefore tax and NICs liability. Those being treated as self-employed may not necessarily understand the implications of this and the deductions they may make. Those treated as employees may well incur significant expenses that they do not, and possibly cannot, deduct. Some are almost certainly treated as self-employed who, on further examination, should be described as employees.

2.35 Some groups of those working at home are better paid than traditional homeworkers. There has been recent research on teleworkers, defined as all people who work at home or use their home as a base at least one day a week using both a telephone and a computer. This group clearly overlaps with but is not synonymous with the homeworkers group defined above. The research includes an analysis of LFS figures (1998) and concludes that 5 per cent of the British work-force can be said to be teleworkers on the above definition.<sup>70</sup>

2.36 Of these teleworkers, 52 per cent are employees and 47 per cent are classified as self-employed. A major factor in considering the conditions of these workers is that many work for transnational corporations and will be doing the same work as those based in other countries. If tax or administrative obstacles are met by the employer/clients, it is a relatively easy matter for them to relocate their operations, as the work can be done wherever they can find workers with the required skills. This could lead to a 'race to the bottom' in terms of worker protection and of pressure for lower taxes and less burdensome regulation of business.<sup>71</sup> On the other hand, there could also be some 'levelling up' of conditions for workers due to globalisation of

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<sup>69</sup> Felstead and Jewson 1999, fn. 60 above.

<sup>70</sup> U. Huws et al., *Teleworking and Globalisation*, (1999) Report 358, Institute for Employment Studies, Brighton. Using a rather narrower definition, the Office for National Statistics gives a figure of 4.3 per cent: Information Society Initiative, *Working Anywhere*, (1998) DTI.

<sup>71</sup> D. Horner and P. Day, 'Labour and the information society: trades union policies for teleworking', (1995) *Journal of Information Sciences*, vol. 21, no. 5, p. 333, discussed in Stanworth 1996, fn. 59 above; Huws et al., fn. 70 above.

corporate cultures. Also, networking between workers in different countries might encourage convergence of pay and conditions, rather than reduction of standards for all. The outcome will depend on how transferable this business and the workers involved in it really are, their networking power and the extent to which the EU and other international bodies can impose standards.

2.37 A DTI booklet designed to encourage teleworking in the UK states:

‘Normally, the distinctions between employee status and self-employment are obvious. However, some workers who appear to be self-employed may for tax purposes be in an employee relationship with an employer.’

This rather confusing statement is followed up by a reference to the Inland Revenue’s booklet IR56.<sup>72</sup> The DTI booklet acknowledges that the tax implications of teleworking differ depending on whether the worker is employed or self-employed, but provides very little advice on this issue other than to suggest that individuals consult an accountant. Development of government policy for this fast-growing sector needs to take into account whether any special allowances or rules may be needed to adapt the taxation system to this new way of thinking.

## **Chapter conclusion**

2.38 The increase in all types of non-standard work poses challenges to the legal system of classification. Tax concepts of employment and self-employment and the consequences attached to these different types of status were developed for the standard work of the early part of the twentieth century. Most people are still in standard work and this may well continue to be the case. But increasing numbers are wholly or partly engaged in variations of this standard pattern.

2.39 In a tax context, this has two main consequences. First, the number of workers at the borderline of the employed and self-employed classification has increased. This puts pressure on the borderline and makes it important that the Revenue authorities can police it adequately. It increases the problems where very different tax consequences flow from classification. It places a heavy weight on this case law classification and on the courts to make it coherent and as far as possible in tune with reality, whilst maintaining a degree of certainty. Second, even where classification is not an issue because a non-standard worker is fairly clearly on one side of the line or the other, the rules developed for standard workers may not fit easily with the increasing number of those who do not follow the standard pattern. Cumulative PAYE, the expenses rules and NICs record rules are all examples of this problem.

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<sup>72</sup> Discussed in Chapter 3 below.

## **CHAPTER 3: LEGAL CLASSIFICATIONS**

As stated in the introduction, legal classification of workers must place them clearly on one side or the other of the employed/self-employed boundary for the purposes of each engagement. This places great strain on decision-making where complex factual situations are concerned. This chapter analyses the case law on worker status, with particular emphasis on income tax and National Insurance. VAT is also referred to. A comparison is made between the approach of the courts in tax and in employment law cases. We note that different tribunals, ostensibly applying the same case law, may come to different conclusions, in part due to the different objectives of the legislation they are considering and the different contexts in which they are considering the cases.

The great weight placed on the facts of each case and the absence of a definitive list of factors or weighting of those factors is discussed. If workers are seen as stretching across a continuous spectrum, as described in the introduction and Chapter 2, then this fact-based jurisprudence accords with reality and gives the courts the best chance of adapting the law to changing work patterns. It also prevents the definition of an employee or self-employed person from becoming formulaic, which could result in manipulation. The case law shows the flexibility needed to meet changing working patterns.

At the same time, the law needs to provide guidance and certainty. The unwillingness of the courts to formulate status decisions as questions of law makes the attainment of certainty difficult and may place strain on the Inland Revenue, business and workers alike. The courts have the scope to lay down a legal framework for guidance and have sometimes, but not always, been prepared to do so. Where different tribunals, ostensibly applying the same test, come to different decisions on the same facts, this is especially confusing. It is misleading to suggest that the courts are applying identical tests where this is not so. It would be preferable for the differences to be clearly stated, and judicial clarification on this would be welcome. Legislative differences may also make this clearer. These are discussed in Chapter 4 below.

### **Introduction**

3.1 The meaning of the terms ‘employee’ and ‘self-employed’ has been evolved through case law. There is no general statutory definition of these terms, but there are statutory definitions of ‘worker’ and statutorily extended definitions of ‘employee’ and related concepts in some employment law, tax and National Insurance legislation. Some legislative provisions treat non-employees as if they were employees and vice versa for some purposes (see Chapter 4 below). The starting-point, though, even in many of the statutory definitions, takes the user back to case law by way of reference to a ‘contract of employment’ or ‘contract of service’.

## *Law and fact*

3.2 One major difficulty is the extent to which classification under the case law is a question of fact, an issue that has been the subject of some considerable discussion in the cases and literature.<sup>1</sup> The emphasis in the status cases on the facts makes worker status often an issue for the fact-finding tribunal at first instance and not for appeal. Only questions of law can be appealed to a higher court. It is sometimes said that the status of the worker is a question of fact and sometimes that it is a question of mixed law and fact.<sup>2</sup> There are primary facts and inferences to be drawn from them, but the inferences are also questions of fact, although they can be overturned by an appellate court if they are insupportable on the basis of the primary facts found by the tribunal.<sup>3</sup> An alternative formulation, which comes to much the same result in practice, is that the badges of the worker's status are a question of law, but that the relative weight to be afforded to those badges in a particular case is a question of fact.<sup>4</sup>

3.3 As discussed further below, it is clear from the status cases in all areas of law that there is no conclusive list of factors to be taken into account and that the weighting of factors in one case may be different from that in others.<sup>5</sup> Equally, it is accepted that the parties may not label their relationship in the way they choose. The true legal relationship between the parties depends upon all the facts and not the label or description the parties may elect for, although the label may be relevant evidence of intention in some circumstances.<sup>6</sup>

3.4 This approach to the facts inevitably limits the uniformity to be found in this area. Were the courts, particularly the higher courts, to wish to impose a more rigid set of criteria and relative weightings, there is no doubt that they could choose to do so by reasserting the extent to which this is a question of law.<sup>7</sup> As Scrutton LJ stated in *Currie v CIR*:

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<sup>1</sup> The leading case is *Edwards v Bairstow and Harrison* [1955] 3 All ER 48. See G. Pitt, 'Law fact and casual workers', (1985) 101 *Law Quarterly Review* 217; T. Endicott, 'Questions of law', (1998) 114 *Law Quarterly Review* 292; the Rt Hon. Sir John Laws, 'Law and fact', [1999] *British Tax Review* 159 (hereafter Laws).

<sup>2</sup> *Lee Ting Sang v Chung Chi-Keung* [1990] 2 AC 374 (PC).

<sup>3</sup> Per Lord Radcliffe in *Edwards v Bairstow and Harrison*, fn. 1 above; see also Lord Brightman in *Furniss v Dawson* [1984] STC at 167.

<sup>4</sup> *Barnett v Brabyn* [1996] STC 716.

<sup>5</sup> *Market Investigations Ltd v The Minister of Social Security* [1969] 2 Q.B. 173.

<sup>6</sup> *Young & Woods Ltd v West* [1980] IRLR 201 CA.

<sup>7</sup> See *Fitzpatrick v IRC (No 2)* [1994] STC 237, where two of their Lordships would have been content to allow different bodies of Commissioners to come to different decisions on different facts but Lord Templeman thought this was unacceptable. In practice, a strong lead was given; this point is discussed in J. Tiley and D. Collison, *UK Tax Guide 2000–2001*, (2000) Butterworths, London (hereafter Tiley and Collison) at para. 1.45.

‘... There has been a very strong tendency, arising from the infirmities of human nature, in a judge to say, if he agrees with the decision of the Commissioners, that the question is one of fact and if he disagrees with them that it is one of law, in order that he may express his own opinion the opposite way.’<sup>8</sup>

More recently, the Rt Hon. Sir John Laws has stated extra-judicially that the boundary between law and fact is not fixed. ‘It depends on what the higher courts think *ought* to be a matter of law: or, more pointedly, what they think should be subject to judicial control.’<sup>9</sup>

3.5 It seems, therefore, that the courts have preferred to leave this question of status flexible as a mixed question of law and fact. The courts are concerned, first, that this might not be appropriate because all the surrounding facts really are of great importance in employment status cases and, second, that they might be crushed by the weight of appeals if all borderline cases were to be considered questions of law.<sup>10</sup> Leaving some issues within the domain of fact has the usual advantages and disadvantages of flexibility: it prevents the manipulation that can result from more rigid criteria and so can lead to justice in individual cases, but it also results in uncertainty.

3.6 The best option seems to be a midway approach that provides a framework of badges or factors. Though it may not be possible or desirable to provide clear weightings or a distinct hierarchy of such factors, the courts can give valuable guidance and be prepared to intervene when the cases arising from the lower courts indicate that governing principles are needed. Lord Radcliffe made this point in relation to the cases on trading in 1955, stating:

‘I think it possible that the English courts have been led to be rather over-ready to treat these questions as “pure questions of fact” ... If so, I would say, with very great respect, that I think it a pity that such a tendency should persist.’<sup>11</sup>

It will be seen in this chapter that some such guidance can be derived from the status cases and, to this extent, it can be said that there are some questions of law in this area.

### ***Different areas of law – different factors***

3.7 In theory, the different areas of law, in which the distinction between the employed and self-employed is of relevance, adopt the same or similar tests, derived from the same case law. In practice, the different tribunals that decide the cases and

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<sup>8</sup> *Currie v CIR* [1921] 2KB 332 at p. 339, cited in Endicott, fn. 1 above.

<sup>9</sup> Laws, fn. 1 above.

<sup>10</sup> Per Lord Griffiths in *Lee Ting Sang*, fn. 2 above.

<sup>11</sup> *Edwards v Bairstow and Harrison*, fn. 1 above, at p. 59.

the different contexts in which they are heard have led to different emphases in the decided cases. Some factors of importance in one area are of much less importance in another. For example, mutuality of obligation is important to establishing employment status under employment law, where the ongoing relationship is significant, but much less so in tax law, where what is significant is usually the relationship at a specific time.

3.8 As discussed in Chapter 5 below, there are different appeal regimes in different areas of law. Tax and NICs appeals systems have differed in the past but, since April 1999, have been brought together under the Tax Appeal Commissioners, as recommended previously by the TLRC.<sup>12</sup> This is welcome, but other tribunals will still be involved in deciding status, notably employment tribunals. In all cases, appeals to the higher courts are on a point of law only. This patchwork quilt of appeals systems, coupled with the limited scope for intervention and guidance by the higher courts due to the emphasis on fact, goes a considerable way to explain the lack of consistency in the cases. The interaction of these systems can be the source of some confusion and anxiety to workers and business owners alike.

### *Other jurisdictions*

3.9 A survey of overseas jurisdictions is outside the scope of this paper, but some points are worth highlighting, drawn from ongoing TLRC research.

3.10 The fundamental problems of classification of workers for tax, social security and employment purposes experienced in the UK are similar to those in all other jurisdictions we have examined, common law and civil and regardless of the absence of a schedular tax system in other jurisdictions. The classification problem is less marked in some countries than others, but this is because there are fewer differences between the two groups of workers so that classification is less important. So, for example, not all countries treat expenses of employees differently from those of the self-employed, but most countries seem to have a classification problem as regards social security contributions. Withholding taxes also create a need for classification, although this may be less acute where all taxpayers fill in a tax return<sup>13</sup> and the withholding system is not cumulative.

3.11 A number of jurisdictions have attempted statutory intervention but this has not been easy either to design or to operate. Most statutory approaches either try an ‘integrationist’ approach, whereby the meaning of ‘employee’ has been extended, or adopt a ‘special cases’ approach, whereby certain types of workers are specifically protected or targeted irrespective of their status.

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<sup>12</sup> TLRC, *National Insurance Contributions Disputes*, (1998) Institute for Fiscal Studies, London.

<sup>13</sup> Or a tax return is filled in on their behalf, in the case of countries with joint assessment of married couples.

3.12 Some jurisdictions have categories of persons who are treated as employees for tax and/or social security purposes because they are considered to be the ‘false self-employed’. In Germany, for social security purposes, for example, a person is classed as an employee if any three of the following five conditions are fulfilled:

- The person does not employ other workers at wages above DEM 630 per month (including family members).
- The person depends strongly upon one employer over a long time.
- The person is employed with tasks for which his employer or a comparable employer usually employs dependent workers.
- The person does not act as an entrepreneur.
- The person is employed with the same tasks by the same employer for whom he or she previously worked as an employee.<sup>14</sup>

3.13 Although at first it might seem helpful to have this statutory intervention, creating some objective tests, some of the tests continue to be subjective and would seem difficult to apply, such as whether the person acts as an entrepreneur.

3.14 Australia has gone much further. From having a system of PAYE that used to require withholding from labour-only suppliers as well as employees, it has now moved to a new integrated pay-as-you-go system (PAYG).<sup>15</sup> Under this scheme, employees are subject to withholding. In addition, broadly, this requires businesses in receipt of goods or labour to withhold 48.5 per cent from payments to any supplier of goods or services not able to quote an Australian Business Number (ABN). There is no entitlement to an ABN unless the supplier is carrying on an enterprise. ‘Enterprise’ is defined to include a business or trade with an expectation of profit. This means that some casual labour-only workers will be covered by the scheme, but the issue of whether they are carrying on a business is not escaped. Where labour-hire firms are used as intermediaries, they, not the client, will be responsible for the deduction. Under this scheme, though it is broad and inclusive, it will still be necessary to classify employees, for whom withholding will be at a different rate, and enterprises entitled to an ABN.

3.15 Complex multi-factorial tests of employment status, like those in the UK, continue to be necessary in Australia and in most other common law countries as their basic starting-point. For example, the revenue authorities in Australia, the US and Canada all issue detailed guidance, which, despite differences in style, are remarkably

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<sup>14</sup> Regelungen gegen Sceinselbständigkeit 1998, as amended by Gesetz zur Forderung der Selbstständigkeit 1999, cited in OECD, *Employment Outlook*, 2000.

<sup>15</sup> New Tax System (Taxation Laws Amendment) Bill (No.1) 1999; Australian Tax Office, *Guide to Pay As You Go for Business* – [www.ato.gov.au](http://www.ato.gov.au).

similar. Starting from the cases on defining independent contractors, or contracts for services as opposed to contracts of service, they contain long lists of factors and are unable to give conclusive advice since all depends on the facts of the case.<sup>16</sup> In the US, the system is based on a 20-factor test derived from case law but contained in a Revenue Ruling.<sup>17</sup> Although this is a little more formal than the application of case law in the UK, the IRS still points out in its guidance that the 20-factor test is ‘an analytical tool and not the legal tool used for determining worker status’. The key issues examined in the US are legal control, financial control and behavioural control. The Canadian guidance lists the four key factors as: control, ownership of tools, chance of profit/risk and integration.<sup>18</sup> Once again, it is explicit that the guidance is merely a tool: a system of formal rulings is available.

3.16 In the US, there is dissatisfaction with the uncertainty surrounding the 20-factor test and there have been various attempts to introduce legislation to define the tests better. For example, the proposed Independent Contractor Clarification Act of 1999<sup>19</sup> would have reduced the 20-factor test to a three-point test. One of these three tests would have been whether the individual encounters entrepreneurial risk. None of these attempts at statutory definition has been enacted and most sound little better than the 20-point test, since they use identical concepts. Complaints from small business about the complexity of the existing test led to the enactment of the so-called ‘section 530 safe harbor’ in the 1978 Tax Bill. This was intended as a temporary solution but was permanently extended in 1982 when nothing better could be devised. It provides relief from past and prospective payments to employers who had a reasonable basis for not treating the worker as an employee. This may consist of reasonable reliance on, for example, a prior IRS audit, a private letter ruling from the IRS, a long-standing industry practice, a court decision, advice from a lawyer or accountant, or any other reasonable basis. Employers must also be able to show reporting consistency and substantive consistency (similarly situated workers must all have been treated in the same way). Various settlements are available short of complete relief.<sup>20</sup>

3.17 It is not easy to devise a test that is more straightforward than that in the case law but that nevertheless retains the flexibility to prevent manipulation and to cover a great variety of situations. Normally, concepts taken from the case law are incorporated into the statutory statements. ‘Safe harbours’ are helpful, but cannot

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<sup>16</sup> Australian Draft Taxation Ruling TR2000/D2; Canada Customs and Revenue Agency RC4110; IRS Worker Classification Training Guidelines: Employee or Independent Contractor (October 1996).

<sup>17</sup> USA Rev. Rul 87-41, 1987-1 C.B. 296.

<sup>18</sup> *City of Montreal v Montreal Locomotive Works Ltd* [1974] 1 D.L.R. 161; *Wiebe Door Services Ltd v M.N.R.* 87 DTC 5025; *Moose Jaw Kinsmen Flying Fins Inc. v MNR* 88 DTC 6099.

<sup>19</sup> Debated in the House of Representatives, 22 April 1999.

<sup>20</sup> IRS, *Employment Tax Handbook*, ch. 6, Classification Settlement Program.

totally remove uncertainty. We therefore turn to an examination of the case law in the UK.

### **Classification case law and income tax**

3.18 Under UK income tax law, employees are taxed under Schedule E and the self-employed under Schedule D, Cases I and II.<sup>21</sup> One person may be both an employee and self-employed for tax purposes in relation to different engagements. There are important differences in the rules and methods applicable to calculation of the taxable income or profits under these different Schedules and to collection of these taxes. It suffices for present purposes to state that the differences can be of significance in some circumstances, making classification for this purpose a matter of potential importance for workers and for those to whom they supply their services alike. A primary difference of great importance to classification is the UK's PAYE system of cumulative deduction of tax at source from employment income.<sup>22</sup> It should be noted that intermediate classifications are possible and do exist. The case law test of employment status has come under the spotlight recently with the introduction of controversial personal service intermediaries legislation, which relies upon this test.<sup>23</sup>

3.19 The Inland Revenue has recently published extensive guidance to classification in its Employment Status Manual (ESM), available on the Inland Revenue's website. In most areas, it seems to reflect the case law in an accurate way, though some aspects where this is not so are referred to below. It contains general guidance followed by more detailed guidance. The *basic* guidance lists and deals with the following factors: control, personal service, provision of equipment, financial risk, basis of payment, mutuality of obligation, holiday pay, maternity pay, sick pay and pension rights, part and parcel of the organisation, right of dismissal, opportunity to profit from sound management, personal factors, length of engagement and intention of the parties. All these are said to be relevant to the basic question of whether the worker is 'in business on his own account'. Much the same list, with some additions, is then reviewed in more detail in a section aimed at Status Inspectors and other specialists.

3.20 The length and complexity of the manual raises questions about the nature of the test. More compact guidance is available in leaflet form (IR56), but this is too brief to be really useful in many borderline cases. Guidance of a meaningful, but more manageable, length, with examples, has been published for those providing personal services through intermediaries (the 'IR35 guidance').<sup>24</sup> Although expressed to be for

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<sup>21</sup> Sections 18 and 19 of the Income and Corporation Taxes Act (ICTA) 1988; for further details, see the Appendix to this paper.

<sup>22</sup> For some more detail on these differences, see the Appendix to this paper.

<sup>23</sup> For this and other special cases, see Chapter 4.

<sup>24</sup> Published in Inland Revenue 45 *Tax Bulletin* February 2000 and also on the Inland Revenue's website.

this particular group, there is no reason why it should not be of value to those engaged directly by a client and wanting to define their status.

### *Early history*

3.21 Tax under Schedule E is charged in respect of any office or employment on emoluments therefrom.<sup>25</sup> Schedule E covered only public offices and public employments until 1922, when all other employments were moved from Schedule D to Schedule E.<sup>26</sup> It was at this stage that the rules for employees and the self-employed began to diverge. As Monroe has described, this does not seem to have been very clearly thought through at the time.<sup>27</sup> As a result of this history, influenced by the concept of the office (previously Schedule E's primary subject matter), the early cases on the meaning of employment, notably *Davies v Braithwaite*, treated the concept of employment as 'analogous to an office'.<sup>28</sup> Rowlatt J said that, in putting employment into Schedule E alongside offices, the legislature had in mind employments that were something like offices, for which he used the expression 'posts'. In the *Braithwaite* case, where an actress was held to be self-employed, the fact that she had a *series* of engagements with a separate contract for each was considered significant. The judge considered her position as a whole and decided that she did not have a post that she stayed in but engagements entered into in the course of a profession.

### *Contract for services or contract of service?*

3.22 Later decisions injected a more modern approach, adopted from cases in other areas of law, and moved away from the concept of the post. These cases use the terminology of a **contract for services** (self-employment) or a **contract of service** (employment). The adoption of this terminology was an early sign of the willingness of the courts to be creative and flexible in their attitude to status.<sup>29</sup> The contract of service test was firmly introduced into tax law in *Fall v Hitchen*,<sup>30</sup> a case concerning a ballet dancer working at Sadler's Wells. There, the previous case of *Market Investigations Ltd v Minister of Social Security*<sup>31</sup> was heavily relied upon in deciding that the ballet dancer was an employee. *Market Investigations* was a decision on the National Insurance Act 1965. This Act expressly defined employment as being 'under

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<sup>25</sup> Section 19 ICTA 1988.

<sup>26</sup> H. Monroe, *Intolerable Inquisition? Reflections on the Law of Tax*, (1981) Stevens & Sons, London, at pp. 25–30.

<sup>27</sup> Monroe, fn. 26 above, at p. 30 explains how this move led to the current expenses rules, outlined in the Appendix to this paper.

<sup>28</sup> *Davies v Braithwaite* [1931] 2 KB 628.

<sup>29</sup> See S. Deakin, 'The evolution of the contract of employment, 1900–1950: the influence of the welfare state', (1998) in N. Whiteside and R. Salais (eds), *Governance, Industry and Labour Markets in Britain and France*, Routledge, London.

<sup>30</sup> *Fall v Hitchen* [1973] 1 WLR 287.

<sup>31</sup> [1969] 2 Q.B. 173.

a contract of service'. Pennycuik VC, in *Fall v Hitchen*, was clear, however, that 'contract of service' was also coterminous with the expression 'employment' in Schedule E of the Taxes Act, even though the tax legislation did not expressly refer to a 'contract of service'.

3.23 Pennycuik VC was of the view that the question whether a contract is one for services or a contract of service 'is for all practical purposes purely one of law'. He saw the question as being one of construction of the written contract before him and the proper construction of document normally is a question of law.<sup>32</sup> This narrow approach contrasted with the *Davies v Braithwaite* approach of looking at the engagement in the context of other engagements.<sup>33</sup> It moved away from the sense of permanence inherent in the *Davies v Braithwaite* decision and meant that a series of short-term engagements would amount to employments more often than previously.

### ***'Control' gives way to 'economic reality test'***

3.24 In *Fall v Hitchen*, Pennycuik VC relied upon the analysis of Cooke J in *Market Investigations*, which reviewed previous decisions on the distinction between a contract of service and a contract for services from various areas of law, both in the UK and elsewhere.<sup>34</sup> Early decisions had placed great weight on control by the 'master' over what was to be done and how it was to be done.<sup>35</sup> Later, it became clear that there may be an employment even where the employee has a particular skill or experience and so will not be told how to do the work.<sup>36</sup> Examples often given are those of employed brain surgeons or masters of ships. They are the experts and will operate or navigate as they see fit, but they are still clearly employees. On the other hand, there may be cases where the engager reserves control over how the work is to be done but the contract is not a contract of service.<sup>37</sup> For example, a window cleaner

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<sup>32</sup> See the comments of Lord Hoffmann in *Carmichael v National Power plc* (HL) [1999] 4 All ER 897, discussed further below.

<sup>33</sup> In fact, in *Fall v Hitchen*, there were no other engagements and the taxpayer required permission to take on work for others, but the Commissioners had found as a fact that Sadler's Wells encouraged artistes to take other engagements and that he had tried to do so unsuccessfully. In the view of the judge, though, what mattered was not whether the taxpayer had one engagement or a series of engagements. He said: 'The fact that an actor normally undertakes a succession of engagements in the course of carrying on that profession in no way involves the result that if an actor enters an acting employment in the nature of a post, then he is not assessable under Schedule E in respect of the income arising from that employment'.

<sup>34</sup> For example, *Whittaker v Minister of Pensions and National Insurance* [1967] 1 Q.B. 156; *Ready Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1969] 1 All ER 433; *U.S. v Silk* (1946) 331 U.S. 704.

<sup>35</sup> For example, *Collins v Hertfordshire County Council* [1947] K.B. 598.

<sup>36</sup> *Morren v Swinton and Pendlebury Borough Council* [1965] 2 All ER 349.

<sup>37</sup> *Queensland Stations Pty. Ltd v Federal Comr. of Taxation* (1945) 70 C.L.R.539.

or interior designer may be subject to stringent controls and restrictions but still be clearly self-employed.

3.25 Cooke J in *Market Investigations* therefore rejected control as a decisive test. He said that it might still be a factor pointing towards employment but it cannot be the sole determining factor. He went on to decide, drawing on North American cases,<sup>38</sup> that the fundamental test is ‘Is the person who has engaged himself to perform these services performing them as a person in business on his own account?’. This is known as the **economic reality test**. This rejection of the control test was another indication of the potential of the courts to develop the concept of employment to meet changing conditions.

### *Independence from paymaster*

3.26 The test of whether the taxpayer is in business on his own account must be considered as part of a wider economic reality. This must also examine the question of integration of the taxpayer into his paymaster’s business. In *Hall v Lorimer*,<sup>39</sup> a freelance vision mixer provided services to a number of production companies under very short-term contracts. The Special Commissioner found that the taxpayer was in business on his own account. The Inland Revenue appealed, contending that this was not the case, based on the following facts: the production company controlled the time, place and duration of any given engagement; the taxpayer provided no equipment; he hired no staff; he ran no financial risk save those of bad debts and being unable to find work; he had no responsibility for investment in or management of the work of programme-making; and he had no opportunity of profiting from the manner in which he carried out individual assignments.

3.27 The decision of the Special Commissioner, that the taxpayer was self-employed, was upheld by Mummery J and also in the Court of Appeal, which treated the question as one of mixed law and fact.<sup>40</sup> In the Court of Appeal, however, Nolan LJ commented that whether the individual is in business on his own account, though often helpful, may be of little assistance in the case of one carrying on a profession or vocation. Nolan LJ rejected a distinction that Counsel for the Crown had sought to make between those selling the product of their labour (self-employed) and those selling their skill or labour itself (employees). This distinction would make it unlikely that a professional person would often be treated as self-employed. As Nolan LJ stated, ‘a self-employed author working from home or an actor or singer may earn his living without any of the normal trappings of a business’. Thus the fact that the taxpayer in this case provided little or no equipment of his own did not defeat his claim to be self-employed for tax purposes. This is a very important decision for service providers and the case will no doubt be relied upon heavily by taxpayers

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<sup>38</sup> *Montreal Locomotive Works Ltd v Montreal and A.G. for Canada* [1947] 1 D.L.R. 161.

<sup>39</sup> [1994] STC 23.

<sup>40</sup> *Hall v Lorimer* [1994] STC 23 at p. 26.

claiming that the personal service intermediaries legislation does not apply to them. The guidance provided by Nolan LJ here is of the type that may help to provide a framework without being too rigid. Whether it is referred to as a point of law or a ‘badge’ or a factor, it is clear that Commissioners deciding that a person was an employee purely because he had no equipment of his own could be reversed by a higher court.<sup>41</sup>

3.28 For this type of case, Nolan LJ preferred what he called the ‘traditional contrast between a servant and an independent contractor’. He considered the extent to which the taxpayer was dependent on or independent of a particular paymaster. This has resonances with the concept of integration into the business, discussed in Chapter 2. It was significant that in this case the taxpayer could and did send substitute workers when he was double-booked and that he worked for 20 or more production companies. In some senses, this was a return to the contextual approach in *Davies v Braithwaite*.<sup>42</sup> The Court looked at the taxpayer’s situation as a whole. This is of vital importance to casual workers providing services for a number of clients. The Inland Revenue has now accepted, in its IR35 guidance and in its general guidance on classification in the ESM, that it is necessary to look at the personal circumstances of the taxpayer as well as the particular contract in question.

3.29 In this case, Mr Lorimer risked bad debts and outstanding invoices and incurred considerable expenditures at a level that the Court of Appeal considered would not normally be associated with employment. There is a fine line here, though, between a self-employed person who takes on these risks and a casual employee who also risks being out of work and losing pay through unemployment and bad health.<sup>43</sup> All employees also risk failure by their employers to pay their wages, due to insolvency. The most outstanding feature of this case was, though, the number of clients Mr Lorimer served. This decision therefore seems to be very much in accordance with a test of ‘economic reality’, although a test based on non-integration with the businesses supplied rather than the taxpayer having the trappings of business himself.

3.30 At first instance in *Hall v Lorimer*,<sup>44</sup> great reliance was placed on an employment law decision of the Court of Appeal, *O’Kelly v Trusthouse Forte plc*,<sup>45</sup> in support of the proposition that a person who is supplying only his own services can be

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<sup>41</sup> See para. 3.47 below for a discussion of the Inland Revenue’s use of this ‘badge’.

<sup>42</sup> C. Whitehouse, *Revenue Law Principles and Practice*, 18th edition, (2000) Butterworths Tolley, London (hereafter Whitehouse), at para. 5.22.

<sup>43</sup> In *Lee Ting Sang v Chung Chi-Keung*, fn. 2 above, cited with approval in *Hall v Lorimer*, it was held by the Privy Council that a casual worker on a building site was an employee for the purpose of employee compensation for injury despite the fact that he risked being out of work. Although this was not a tax case, its applicability to tax cases was not disputed in *Hall v Lorimer*.

<sup>44</sup> [1992] STC 599.

<sup>45</sup> [1984] QB 90.

self-employed. In *O’Kelly*, however, the Court of Appeal had expressly ignored the tax and National Insurance position of the employees concerned. In the Court of Appeal in *Hall v Lorimer*, it was not necessary for Nolan LJ to comment on the relevance of *O’Kelly*, since he considered the other authorities cited were sufficient to support the Court’s decision. This leaves the significance of *O’Kelly* for tax cases in some doubt.<sup>46</sup>

3.31 Counsel for the Inland Revenue in *Hall v Lorimer* expressed concern in argument that the effect of a decision in favour of the taxpayer would be to erode the scope of Schedule E in the case of casual employments. The number of paymasters served, however, did seem to differentiate Mr Lorimer from other casual employees, although at what number the line should be drawn is difficult to say and does not seem to be susceptible to a formula. Putting a number on this test would inevitably be an arbitrary exercise and the test would be relatively simple to manipulate.

### ***Weighing all the factors and the intention of the parties***

3.32 These cases give some level of guidance and establish some issues that can be stated to be questions of law, but much is left to be decided as a question of fact. The factors to be considered can be derived from the cases and listed, as the Inland Revenue has done in the ESM cited above. This is also done in many of the textbooks and it gives a series of factors somewhat similar to the US’s 20-factor test and lends a sense of order and balance to the exercise. This can be spurious, however. A factor that is important in one case can be irrelevant in another. Care must be taken not to imply that there are relative weightings to these factors that apply in each case.<sup>47</sup>

3.33 Lightman J in *Barnett v Brabyn*<sup>48</sup> described the factors that are relevant to deciding employment status as ‘badges of potential significance’. He accepted that there were questions of law involved in deciding on status. The following are statements of law, for example: that a person who merely renders his services may nevertheless be self-employed,<sup>49</sup> that it is a badge of a contract of service that there is conferred a first, and *a fortiori* an exclusive, call upon the services of the individual

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<sup>46</sup> Discussed further later in this chapter.

<sup>47</sup> In her recent book on personal service intermediaries, Redston divides status tests into fundamental status tests, important status tests and minor status tests. Whilst apparently helpful, this approach could mislead since, under current law, it is the whole picture that must be looked at and an unduly scientific explanation might be incorrect on the facts of a particular case. Her criticism of the Inland Revenue for not giving guidance on the hierarchy of the tests, therefore, seems misplaced, even though it would be useful if such a clear hierarchy as she suggests were to exist – A. Redston, *IR35: Personal Service Companies*, (2000) abg, London (hereafter Redston), ch. 6.

<sup>48</sup> Fn. 4 above, at p. 724.

<sup>49</sup> *Hall v Lorimer*, fn. 39 above; *O’Kelly v Trusthouse Forte plc*, fn. 44 above. This is obviously a point of great significance in the light of the legislation on personal service companies discussed in Chapter 4 below.

concerned<sup>50</sup> and that weight can be given to the parties' intentions.<sup>51</sup> Having said this, however, he explained that these badges may carry greater or lesser weight depending upon the context of the case. On the very unusual facts before him, factors that would normally indicate employment did not carry much weight.

3.34 Mr Justice Lightman considered that 'factors relevant in one situation may be irrelevant or of no weight in another'. Further, he stated that the labels the parties decide to give the relationship may or may not be relevant. Such a label must be disregarded if inconsistent with the effect of the contract as a whole, but can be decisive where the terms of the contract are consistent with either relationship.<sup>52</sup>

3.35 Accurate as Mr Justice Lightman's summary of the position appears to be, it is of very little use in giving day-to-day guidance to those on the ground, who must apply the law and make decisions based upon it: business owners, workers, advisers and Inland Revenue officials. Business owners and workers can be forgiven for feeling confused and finding this a costly and exasperating aspect of the tax system if they are operating in a non-standard situation that is at the status borderline.

3.36 In *McManus v Griffiths*,<sup>53</sup> Lightman J warned that taxpayers should be wary about making informal agreements without appropriate professional advice. In this case, an employed golf club stewardess was required by her contract, in addition to her other duties, to provide a catering service for the club. She was assessed on the catering profits under Schedule D Case I on the basis that she was running a business on her own account. In the circumstances of that case, Lightman J considered that the taxpayer's status was entirely a question of proper construction of the contractual documents 'viewed in the matrix of facts in which they were signed' and was therefore a question of law. The taxpayer had control of the menu and prices and a free hand in the employment of staff, and so it was held that the catering service she provided was a business and not part of her employment.

3.37 The facts of this case were unusual, but the parties were not particularly sophisticated and there is no evidence in the case that this was a tax avoidance exercise. The club secretary drew up the documents and does not appear to have considered their tax implications. Although the judge commented that the club secretary should have sought professional advice, there is a problem in knowing when such advice is needed. Moreover, it is questionable whether taxpayers and business

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<sup>50</sup> *Fall v Hitchen*, fn. 30 above.

<sup>51</sup> *Massey v Crown Life Insurance Co* [1978] 2 All ER 576.

<sup>52</sup> In this, the judge followed with approval an employment law case, *Massey v Crown Life Insurance Co*, fn. 51 above, discussed further below. Contrast the comment of the New Zealand Court of Appeal in *TNT Worldwide Express (New Zealand) Ltd v Cunningham* [1993] 3 NZLR 681 – 'there are many reasons why both employer and contractor prefer the independent contractor arrangement. They should be free to exercise their choice without paternalistic intervention by the Courts.'

<sup>53</sup> [1997] STC 1089.

owners should need to seek professional advice in their everyday affairs in this way. If they do seek such advice, can certainty be achieved? On the same judge's own admission in *Barnett v Brabyn*, just one year before, factors of importance in one case will be insignificant in another. This will hardly give even experienced practitioners confidence that they can give accurate advice in borderline cases.

3.38 It is unfortunate that the facts of *Barnett v Brabyn* were quite so unusual. Lightman J's listing of the factors that might be seen as questions of law did, in fact, give guidance on what should be considered and what might be discounted, even though no weightings could be attached.

### ***Inland Revenue guidance***

3.39 The Inland Revenue has issued the various forms of guidance described above: IR56, the IR35 guidelines and the ESM.<sup>54</sup> In addition, there is a booklet (IR175) entitled 'Supplying services through a limited company or partnership', and more extensive guidelines are also contained in special material for the construction industry.<sup>55</sup>

### **IR56**

3.40 IR56, the basic leaflet prepared for taxpayers, was updated in April 1999 and is now available on the Inland Revenue's website. In the Inland Revenue's own listings of leaflets, it is stated of IR56 that 'This can help you decide whether or not you are employed or self-employed, an area that causes a lot of confusion'. IR56 would be unlikely to help much with that confusion in anything other than a reasonably clear case. It is arguable, moreover, that it does not wholly reflect the *Hall v Lorimer* decision.<sup>56</sup>

3.41 IR56 lists questions to be applied to *each separate job* and states: 'You'll need to look at your *job* as a whole', rather than suggesting that one needs to look at each job in the context of all activities of the taxpayer. It does state at a later point:

'Where, however, you provide services to many different persons and do not work regularly for one person to the exclusion of others, this may be relevant to the decision whether your work for each is as an employee, or a self employed person.'

3.42 This is not given prominence by placing it within the key questions, however. This contrasts with the layout of IR175, published in 2000, which asks similar questions to those in IR56, but follows them up immediately with the comment that

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<sup>54</sup> Paras 3.19 and 3.20 above.

<sup>55</sup> IR148/CA69, 'Are your workers employed or self-employed?', was produced for the construction industry in 1995. See also Inland Revenue 28 *Tax Bulletin* April 1997, p. 405.

<sup>56</sup> See Whitehouse, fn. 42 above, at para. 5.22; Tiley and Collison, fn. 7 above, at para. 51.03.

the number of clients overall may be relevant. In IR56 and IR175, there is still a great emphasis on providing tools and risking one's own money 'in the business' – an emphasis which may now be misleading.

3.43 IR56 is inadequate for those at the borderline – the very people who particularly need assistance. Now that more detailed and, normally, more accurate guidance has been provided in the IR35 guidelines and the ESM, it would be helpful if IR56 could be revised and updated to take *Hall v Lorimer* into account more fully and clearly. Given the effort being made to assist those with personal service intermediaries, a rather more detailed leaflet for general guidance would also be desirable.

3.44 The more detailed guidance now available is helpful and welcome. All such guidance is problematic also, however. If it is too brief, like IR56, it risks being of little use in the difficult cases where it is most needed. If it is too detailed, it may become off-putting and burdensome to the people for whom it is intended. The ESM is very long and detailed. It is accessible on the Inland Revenue website, free of charge and carefully indexed and divided into bite-sized sections.<sup>57</sup> It is, of course, designed for Inland Revenue staff and not the public. It will also be valuable to tax professionals. It would be very difficult for an ordinary member of the public to use, however, because the level of detail might bewilder rather than clarify. This is why an intermediate document, somewhere between IR56 and the ESM, is needed for general purposes.

### IR35 guidance and the ESM

3.45 The analysis in the IR35 guidance does pay more heed to *Hall v Lorimer* than does IR56. It also gives some useful examples of application. It commences by emphasising that classification of workers is not a mechanical exercise of weighing up factors but one of looking at the picture as a whole, and the method of dealing with the examples bears this out. It then lists factors to be considered. It commences with control, which is an odd choice of starting-point since, as seen above, this factor has played a less prominent part in recent case law. The analysis makes it clear that the right to determine how the work is done is not an essential feature of employment, but places more weight on the ability of a client to say what work is to be done and when. If the worker is required to work as part of a co-ordinated team, for example, that is said to point to employment. Of course, many consultants will have to work *with* a team but this will not make them part of the team. The examples given show the difference between being part of a team and checking on its operation, but this might not be so clear from the guidance.

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<sup>57</sup> This accessibility is welcome, although the fact that the ESM can only be read and printed off in these paragraph-length sections is inconvenient.

3.46 The discussion in IR35 of the right to use a substitute seems unexceptionable. It is established in the cases that the right to send in a substitute does suggest that the personal relationship inherent in an employment contract is not present.<sup>58</sup> The recent confirmation of this in the employment case of *Express and Echo Publications v Tanton*<sup>59</sup> seems to have made the Inland Revenue nervous, which is understandable, since much weight was placed by the Court of Appeal in that case on what was agreed rather than on what actually occurred. There is a reasonable concern that a clause could be inserted into a contract stating that substitution was possible without any intention of actually relying on that clause. It is notable, however, that the permission to substitute in the *Echo* case was expressly held not to be sham, so that it is clear that any such provision must be genuine. The Inland Revenue has now stated, in its answers to frequently asked questions on IR35, that there is no genuine right to substitute where the client does not mind, from one day to the next, who carries out the work. This seems to go beyond the case law: no doubt the client had a preference in *Hall v Lorimer* and *Echo* for its original choice of worker, but that did not negate the importance of the right to substitute if it was not a sham.<sup>60</sup>

3.47 The section in the IR35 guidance on equipment may also give too much emphasis to a particular point. It states that

‘where an IT consultant is engaged to undertake a specific piece of work and must work exclusively at home using the worker’s own computer equipment that will be a strong pointer to self-employment. But where a worker is provided with office space and computer equipment that points to employment’.

Given the complexity of modern equipment and systems, consultants will often need to work on their clients’ equipment to check out systems or to ensure that their work is compatible with that of the business and of the right quality. Mr Lorimer used the film studio’s very expensive equipment but this did not prevent him from being self-employed. It is clear from the Inland Revenue’s own example of Charlotte, a borderline worker who it ultimately decides would be self-employed, that using the client’s equipment is only a pointer towards employment and not fatal to a claim of self-employment. Overall, the IR35 guidance gives completely fair guidance, but a lay person reading it could be forgiven for thinking that use of the client’s equipment would be more important than it might turn out to be.

3.48 The section dealing with this in the ESM<sup>61</sup> is more balanced, as it can be because it is more detailed. Redston<sup>62</sup> points out, however, that the ESM misleadingly refers to Mummery J in the High Court rather than to the Court of Appeal decision, in which, as we have seen, Nolan LJ gave no importance to equipment or the other

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<sup>58</sup> *Ready Mixed Concrete v Minister of Pensions* (1968) 2QB 497.

<sup>59</sup> [1999] ICR 693 CA, discussed at para. 3.87 below.

<sup>60</sup> See Redston, fn. 47 above, at p. 109 on this point.

<sup>61</sup> ESM 1062.

<sup>62</sup> Redston, fn. 47 above, at p. 113.

trappings of business in the case of someone carrying on a profession. The difficulty is not so much, though, that the emphasis should be on one point or another: all the points mentioned by the Inland Revenue are relevant and would certainly be used by Counsel in argument or cited in a textbook. The problem for the taxpayer is that he does not wish to engage in an intellectual debate about the factors in his particular case, but rather he wants a clear answer. As this discussion shows, despite all its efforts to give clear guidance, the Inland Revenue cannot give firm answers because these do not exist in the light of the importance placed by the courts on the facts of each case.

3.49 In referring to financial risk as a factor, the IR35 guidance makes an interesting point. It states that where a skilled worker incurs significant amounts of expenditure on training to provide himself with a skill that he uses in subsequent engagement, this can be seen in the same way as an investment in equipment, since he might not recover the cost from his income. Thus it is a pointer to self-employment. This could be very helpful to workers using personal service companies, who are currently complaining that they will not be able to deduct all their training expenditure under the new legislation. Perhaps the answer to them is that if the expenditure is substantial, they can argue that the new legislation should not apply to them, relying on this point.

3.50 Personal factors, particularly the number of clients worked for throughout the year, are listed in the IR35 guidance and the ESM, giving proper weight to *Hall v Lorimer* on this point. The number of clients is stated to carry less weight in the case of an unskilled worker, which is consistent with Nolan LJ's comments in that case. Once again, this shows that what is a very significant factor in the hierarchy in one situation is less so in another. Another related factor is the length of the engagement, although the IR35 guidance makes it clear that a series of short contracts with one client will be looked at as one longer engagement. Any other approach would give obvious scope for avoidance. Whether the worker has a businesslike approach and has office accommodation and equipment is also referred to in this context, though this was not of major significance in *Hall v Lorimer*. It could, however, be important in building up the overall picture.

3.51 The IR35 guidance and the ESM go through other factors also: basis of payment, opportunity to profit from sound management, whether the worker is part and parcel of the client's organisation, employee benefits, the right of dismissal and the role of intention. The most useful aspect of the guidance is the IR35 examples, because they explain the process of balancing factors in a way that it is impossible to do within a list of considerations. Use of similar but more wide-ranging examples within a more general guidance booklet for the public would be welcome. Even then, each case will involve a considerable amount of subjective judgement.

## Tax guidance and other areas of law

3.52 As we shall see, one difficult and confusing issue for workers seeking to establish their status can be that their status for tax purposes is different from that for other purposes, or that the authorities are seeking to treat them differently for the purposes of different taxes (for example, VAT and income tax).

3.53 The Inland Revenue guidance is unable to provide any reassurance on that score. IR56 states that

‘Other considerations may also be relevant [in employment law matters], so your position under employment law will not necessarily be the same as under tax and National Insurance law. For employment protection purposes the industrial tribunals, which are independent bodies, will decide whether someone who makes a complaint is employed or self-employed’.

3.54 This is, as we shall see, a factually correct statement, but it gives no indication of how or why the position might differ under employment law and tax law. There are some statutory differences, but for the most part the taxpayer will be advised, if he asks, that the tests are the same. This, then, is confusing advice.

3.55 When we turn to the more detailed ESM, we find Inland Revenue staff being advised that they are not bound on the question of the income tax status of an individual on the basis that they have registered for VAT, made returns assuming self-employment, applied and been accepted to pay self-employed NICs or received a decision from an employment tribunal.<sup>63</sup> Again, this is factually correct, but it is stated baldly with no explanation, though it can leave the taxpayer in a very difficult situation. Inland Revenue staff are told, however, that their opinion might directly affect benefit entitlement and indirectly affect such matters as VAT.<sup>64</sup>

3.56 There are some clues to the differences between tax and employment law considerations in the body of the ESM. One factor, which is not discussed in IR56 or the IR35 guidance, but which is dealt with in the ESM, is that of mutuality of obligation; that is, whether there is an ongoing requirement to provide work and to accept it. This, we shall see,<sup>65</sup> is an important factor in a number of employment law cases. Because of the requirements of continuity and length of service in employment law, the worker often needs to show that an umbrella employment exists, not just a series of short contracts of employment. For income tax purposes, this will have fewer implications, since tax and NICs will be payable on what has been earned whether the contract of employment is short-term or part of a longer-term arrangement. A short-term contract may nevertheless be a contract of employment, for tax and employment law purposes.

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<sup>63</sup> ESM 0112; ESM 1071.

<sup>64</sup> ESM 0005.

<sup>65</sup> See *Carmichael v National Power plc*, fn. 32 above, discussed at para. 3.85 below.

3.57 On mutuality, the ESM states:

‘This aspect is rarely of practical use when considering status from a tax or NICs point of view and it can confuse the issue ... Do not consider this factor when reviewing a worker’s status, unless the engager or worker raises it.’

There is something a little unhelpful about the way this is phrased, since the taxpayer may be confused by references to mutuality in an employment context and may need help with understanding why this is less relevant for tax purposes. The ESM reiterates the requirement on the Inland Revenue under its Service Commitment to help taxpayers get their affairs right<sup>66</sup> and this might involve discussion of mutuality.

3.58 The Inland Revenue’s approach is also a little surprising, since one might expect that it would sometimes wish to utilise the mutuality factor to show that a contract of employment *does* exist. It is true that the absence of a mutual obligation to provide further work and to take it up will not mean that there is no short-term contract of employment in relation to work actually done. In the IR35 guidance, however, the Inland Revenue states that ‘regular working for the same engager may indicate that there is a single and continuing contract of employment’.<sup>67</sup> Mutuality would be an issue in any such claim, since the taxpayer might argue that there was a series of short-term contracts, which, taken with other factors, pointed to self-employment over all. To isolate one set of contracts as an employment contract would require mutuality. The Inland Revenue might have cause to regret the downplaying of this concept in its guidance in the future.<sup>68</sup>

3.59 The complexity and uncertainty surrounding the classification cases in tax law may result in the taxpayer needing to obtain detailed personal advice from the Inland Revenue on his tax and National Insurance position. Each Inland Revenue Enquiry Centre, Tax Office and Inland Revenue (NI Contributions) local office has a nominated officer responsible for enquiries and decisions about employment status who can be required to give written advice.<sup>69</sup> This is not always a quick and straightforward procedure, as discussed in Chapter 5, where appeals from such decisions are also discussed. A recent survey on tax compliance costs for employers found that employers felt they needed clearer guidance on employment status, especially in relation to casual workers.<sup>70</sup> The newly published ESM might help, but some more compact guidance giving examples is needed.

3.60 The alternative route to advice is to turn to lawyers and accountants, although, as seen from the above discussion, the task of advising on what is, to a considerable

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<sup>66</sup> ESM 0005.

<sup>67</sup> It cites *Nethermere (St Neots) Ltd v Gardiner* [1984] ICR 612 in support.

<sup>68</sup> Redston, fn. 47 above, at p. 108 suggests that it might be used in litigation in future in relation to IR35.

<sup>69</sup> IR56 and ESM.

<sup>70</sup> The Bath Report, fn. 8 Introduction above.

degree, a question of fact is not necessarily straightforward even for those so qualified. What is more, this can add to the cost of setting up and running a business, especially a small business.<sup>71</sup>

3.61 The new focus on classification under the personal service intermediaries legislation is likely to concentrate further attention on the income tax case law tests. It is very probable that we shall see litigation brought by those affected by the new legislation. If the courts, however, continue to apply their current, very fact-based, approach to this legislation, it will not necessarily result in useful precedents. Possibly the courts will accept the need to lay down further guidance, as they have in the past when absence of guidance on the meaning of words in tax law has caused problems.<sup>72</sup>

3.62 We should not underestimate the ability of the courts to make an impact, should they wish to do so. It is clear from the discussion above that a number of cases have had a significant impact in bringing the law into line with modern economic conditions – for example, by reducing the importance of the control test and by making it clear that having no equipment does not necessarily make the taxpayer an employee. In many ways, case law is far better suited to this area than would be statutory rules, but, as ever, there is a need to balance the need to retain flexibility with the need for certainty in commercial arrangements. Personal service companies have been used as a way of escaping uncertainty in the past; the removal of this escape route may place additional strain on a legal test already under pressure.

### **Classification case law and NICs**

3.63 Liability to NICs and the class of NICs to be paid depend upon whether the payer is an employed earner or self-employed.<sup>73</sup> An employed earner is defined as ‘a person who is gainfully employed in Great Britain either under a contract of service or in an office (including elective office) with emoluments chargeable to income tax under Schedule E’.<sup>74</sup> The question of whether a person is working under a contract of service is the same question as that which has to be answered for income tax and employment law purposes, and one would expect the same case law to be applied when addressing that part of the NICs definition.

3.64 In the past, National Insurance status cases have reached the High Court via a determination of the Secretary of State, via an inquiry of the Office for the Determination of Contribution Questions (ODCQ). These decisions were once published, but publication ceased on grounds of confidentiality.<sup>75</sup> What follows refers

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<sup>71</sup> The Bath Report, fn. 8 Introduction above.

<sup>72</sup> As in the case of the meaning of ‘trade’, for example, although this too is still a concept around which there can be uncertainty.

<sup>73</sup> See Appendix to this paper for details.

<sup>74</sup> Section 2 of the Social Security Contributions and Benefits Act 1992.

<sup>75</sup> Tiley and Collison, fn. 7 above, at para. 51.02.

briefly to some of what is known of the jurisprudence arising from this route. As discussed in Chapter 5 below, such cases are now being heard initially by the Tax Appeal Commissioners. This is a welcome change, which should go a long way to improving consistency of decisions in the future for tax and National Insurance purposes. Moreover, as explained further in Chapter 5, the Inland Revenue is now responsible for NICs, following merger with the Contributions Agency. The ESM, discussed above, is now the guidance that applies for NICs issues as well as taxation. Hopefully this will bring the decisions into line in the vast majority of cases.

3.65 There are some important statutory differences between tax and National Insurance classifications where the Social Security (Categorisation of Earners) Regulations<sup>76</sup> apply. The details of these Regulations and their rationale or lack of it are discussed in Chapter 4 below. The following discussion applies to the majority of cases where those special statutory classifications do not apply, so that the case law governs the position and, theoretically at least, the test is the same as for tax cases.

3.66 The leading case of *Market Investigations*,<sup>77</sup> establishing the so-called economic reality test, has been discussed above and it should be noted that, although this was a National Insurance case, it has been widely applied in a tax context. In practice, though, especially where tax and National Insurance cases arise in different contexts, differences in emphasis can arise. In particular, if the issue of National Insurance status arises in the context of benefit entitlement,<sup>78</sup> there may be issues of continuity of service to consider. This gives the National Insurance cases a hybrid quality: in theory, they need to ‘fit’ both tax and employment law decisions, which can be difficult, if not impossible, due to the divergences created by the different appeal systems. Although this will be met in part by the fact that National Insurance cases will now be heard by tax tribunals, the cases may still arise in rather different circumstances that could affect the approach of the courts.

3.67 For example, the mutuality of obligations questions, discussed elsewhere in this paper, could be more important in relation to NICs than they are in relation to taxation. Thus statutory sick pay is only payable if a contract of employment lasts for more than three months. The tax tribunal will be used to a situation in which it only has to decide whether a short-term engagement is a contract of employment or not. For deciding entitlement to statutory sick pay, however, it may also need to consider whether there is an umbrella contract, so mutuality will be an important factor. It remains to be seen exactly how the Tax Commissioners will evolve this jurisdiction and to what extent decisions in one area will affect the other.

3.68 In the past, National Insurance decisions seem to have taken as their starting-point an employment case, *Addison v London Philharmonic Orchestra Ltd.*<sup>79</sup> This

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<sup>76</sup> SI 1978/1689 as amended.

<sup>77</sup> Discussed at paras 3.22 *et seq.* above.

<sup>78</sup> As it may do under section 8 of the Social Security (Transfer of Functions etc. ) Act 1999.

<sup>79</sup> [1981] ICR 261.

case set out the questions to be asked in deciding employment status, known as the ‘*Addison* tests’, although the case did not originate these tests but merely drew them together from the earlier cases. These tests were adopted as the basis for an interview format to guide local DSS and Inland Revenue staff on status determinations prior to the merger of these organisations.<sup>80</sup> The *Addison* tests were similar in most respects to the ‘badges’ applied for tax purposes, but not identical. For example, the basis of income taxation paid by the worker appears as one of 21 factors and is not seen as determinative of the issue.

3.69 Even prior to the merger of the Inland Revenue and the Contributions Agency, however, the intention was that both bodies should have a *common approach* to the determination of employment status.<sup>81</sup> In the past, differences have still arisen. The author has on file details of the case of Mrs Patel,<sup>82</sup> where an ODCQ inquiry came to the conclusion that a homeworker was employed, despite an earlier finding by the General Commissioners that she was self-employed.<sup>83</sup> An industrial tribunal had held that the same worker was an employee and that she was entitled to compensation for unfair dismissal.

3.70 The ODCQ Inquirer was aware of the previous decisions but refused to take account of them when Mrs Patel’s case came before him. He quoted Rose J in *Renn-Jennings v The Secretary of State*,<sup>84</sup> who said, in a similar situation, ‘it is the Secretary of State who is expressly empowered to determine the matter and the exercise of this power cannot be pre-empted or inhibited by the findings of another tribunal’. The Inquirer therefore stated that the matters in the *Patel* case would be the subject of full and fresh consideration by the Inquiry. Hopefully, confusing occurrences such as this will now be avoided, though it is to be noted that the employment law decision differed from that of the Tax Commissioners and nothing has occurred to change this possibility.

3.71 The case stated of the General Commissioners in the *Patel* case notes that the Inspector of Taxes for the Inland Revenue argued that it regarded all textile outworkers as self-employed. This seems to have been a settled local position and the local General Commissioners were not inclined to question it. The Inquirer was looking at the issue from a more detached legal position and applied the *Addison* tests that originated in employment law. For the Commissioners, the issue was whether the

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<sup>80</sup> DSS, *A Review of Legislation on Employment Status for National Insurance Purposes* (unpublished report 1994) (hereafter the DSS 1994 report), at p. 23 and Appendix C. The author is grateful to the DSS for making this report available.

<sup>81</sup> DSS and Inland Revenue, *The Common Approach*, (1994) Final Report March, and see Chapter 5, fn. 12 below.

<sup>82</sup> The attention of the author was drawn to this case by David Brodie of TaxAid and TLRC member. The author would like to acknowledge the assistance of the Leicester Outwork campaign in providing details and documentation, which the author has on file.

<sup>83</sup> Under the new system outlined in Chapter 4, this should not be possible.

<sup>84</sup> A decision of Rose J in the High Court (CO/1132/87), 12 May 1988 (unreported).

client/employer should have paid tax under PAYE, but for the Inquirer the focus was on entitlement to benefits.

3.72 Under the new appeal arrangements, both issues would be considered by the Tax Commissioners, but how they will deal with the different considerations arising is not yet clear. The problem remains that, although we might expect a person's status to be identical for tax and National Insurance purposes under the new system, National Insurance issues may arise in a situation where an employment tribunal has come to a different conclusion on employment law status. National Insurance continues to have a difficult hybrid status in this situation.

## **Employment law**

### ***The purposive approach***

3.73 The 1993 version of the Inland Revenue and Contributions Agency guidelines in IR56/NI39 stated that the same guidelines applied for employment law as for tax and National Insurance. By 1995, when IR56 was updated, however, the position was stated to be that there could be differences, as discussed above.

3.74 This change in wording reflects the purposive approach of the employment (formerly industrial) tribunal<sup>85</sup> and employment appeals tribunal, which tend towards finding the existence of 'employment' which then gives them jurisdiction to apply the employment protection legislation. The employment tribunals are quite openly enthusiastic about preventing employers from using devices to escape the full effect of this legislation and it is recognised that they take a purposive approach to employment protection legislation where possible.<sup>86</sup> The employment tribunals and employment law literature generally are comfortable with the idea that the word 'employee' must be construed in the context of the relevant legislation. So, one leading text states:

'The answer to the question "Servant or not?" may depend upon the purpose for which you want to know. Obviously, different tribunals may reach different conclusions on the same facts. Thus an industrial tribunal may regard a worker as a servant for the purposes of unfair dismissal or redundancy, despite the fact that the Inspector of Taxes has held him to be self-employed for tax purposes (*Airfix Footwear Ltd v Cope*<sup>87</sup>) ... Different policy considerations apply. In the case of vicarious liability, the court will mainly be concerned with adequate protection of innocent third parties; in the case of National Insurance, with the improper avoidance of contributions and so on.'<sup>88</sup>

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<sup>85</sup> Note that since August 1998 industrial tribunals are known as employment tribunals.

<sup>86</sup> For a recent statement on this, see *Johnson v Ryan* [2000] ICR 236.

<sup>87</sup> [1978] ILR 1210.

<sup>88</sup> See B. Perrins (ed.), *Harvey on Industrial Relations and Employment Law*, (1972) loose-leaf, Butterworths, London, at A[9] (hereafter Perrins).

3.75 This should be contrasted, however, with the Court of Appeal's view in *Bottrill*<sup>89</sup> that there was no justification for giving the term 'employee' special meaning for the purposes of the Employment Rights Act 1996. There was no justification for departing from employment law generally or for distinguishing *Lee v Lee's Air Farming Ltd*,<sup>90</sup> a case on corporate personality. This was a very significant statement from Lord Woolf MR, which should carry great weight, but it is not clear whether it will be picked up and followed in the employment tribunals. *Bottrill* continued to lay stress on the facts, which leaves significant scope for interpretation to tribunals.

3.76 As one employment law text argues, although the vagueness of the status test may be unsatisfactory from an analytical point of view, it reflects the practical position.<sup>91</sup> These authors contend that it is appropriate for lay members of employment tribunals to apply their industrial experience to the resolution of status issues in the context of modern statutory rights.<sup>92</sup> Sometimes, though, they will be seen as having gone too far by the higher courts. Thus, in *Costain Building & Civil Engineering Ltd v Smith*,<sup>93</sup> the Employment Appeal Tribunal allowed an appeal on the basis that the tribunal had lost sight of the facts and was perverse to look through an agency agreement and construct an employment contract between the applicant and the contractors. There can be no doubt, though, that the tribunal members' backgrounds will make a purposive approach appealing to them.

3.77 It was observed in the DTI employment status report referred to above<sup>94</sup> that to take this approach to the extreme would make it impossible to predict how the courts would decide the status of a particular individual. This report comments that uncertainty mainly arises in practice in non-standard employment relationships. Although it considers that some degree of uncertainty in the operation of the law in this area is probably unavoidable, it comments that '... a situation in which a substantial proportion of the workforce is unsure as to its legal position would give rise to concern.' The report then goes on to examine empirically the extent to which there is uncertainty about status amongst non-standard workers. It concludes that the legal division for employment law purposes between employment and self-

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<sup>89</sup> See discussion at paras 3.97 and 3.98 below.

<sup>90</sup> [1961] AC 12.

<sup>91</sup> I. Smith and G. Thomas, *Smith and Wood's Industrial Law*, 7<sup>th</sup> edition, (2000) Butterworths, London (hereafter Smith and Thomas 2000), at p. 12, citing *Challinor v Taylor* [1972] ICR 129 and *Thames Television Ltd v Wallis* [1979] IRLR 136.

<sup>92</sup> An employment tribunal consists of a legal chairman and two lay members. The latter are selected from a panel drawn up after consultation with representatives of employers' organisations and trade unions. There will usually be a representative from each side of industry, though a chairman can sit with only one lay member if both parties agree and without a lay member in some cases – N. Selwyn, *Selwyn's Law of Employment*, 11<sup>th</sup> edition, (2000) Butterworths, London (hereafter Selwyn), at p. 7.

<sup>93</sup> [2000] ICR 215.

<sup>94</sup> Fn. 23 Introduction above.

employment does not correspond to perceptions of a clear divide between these different forms of work on the part of many individuals in non-standard employment.

### *Employment law tests*

3.78 The Employment Rights Act 1996 and other employment legislation define ‘employee’ as one who works (or worked) under a contract of employment, and a contract of employment is in turn defined as a contract of service or apprenticeship.<sup>95</sup> This means that the case law is of prime importance. The modern tendency has been to use the contract of employment concept as the central one, but to extend it according to the purpose of the legislation, sometimes covering also all those employed under ‘a contract personally to execute any work or labour’. More recently still, the favoured approach has been to use the term ‘worker’. Even the extended definitions of ‘worker’, discussed in Chapter 4, however, make reference to work under a ‘contract of employment’ as a component of that definition. Therefore the question of what is a contract of service remains significant.

3.79 This development of broader statutory definitions encourages employment tribunals to think of status questions more generally in a wider and purposive context.<sup>96</sup> One leading text states of these extended definitions: ‘It must thus be clear that the law may categorise workers as it wishes in accordance with the objectives to be achieved’.<sup>97</sup>

3.80 Despite these wider definitions, the starting-point, and in some cases the only true issue for the courts, is the application of the case law on the meaning of contract of service. As for tax and National Insurance, the cases apply a mixed test balancing the various factors of personal service, control, integration into the organisation,<sup>98</sup> criteria of service and, of course, the economic reality test, which can be said to subsume them all.<sup>99</sup> Control has been severely criticised as a test in the employment law literature. One commentator has gone so far as to state that ‘the right of control fails to distinguish employment from self-employment because its presence is entirely consistent with either type of contract’.<sup>100</sup>

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<sup>95</sup> Section 230.

<sup>96</sup> General and Municipal Boilermakers (GMB) National Office Project Team, *Employment Status: Recommendations for Reform*, (1997). The author is grateful to the GMB Legal Department for making this report available and discussing it with her. It has been used throughout this section on employment law.

<sup>97</sup> Selwyn, fn. 92 above, at para. 2.92.

<sup>98</sup> *Stevenson Jordan and Harrison Ltd v MacDonald and Evans* [1952] 1 TLR 101, CA.

<sup>99</sup> For a good discussion of the employment law tests, see the DTI employment status report, fn. 23 Introduction above.

<sup>100</sup> The DTI employment status report, fn. 23 Introduction above, at 2.1.1, citing D. Brodie, ‘The contract for work’, (1998) *Scottish Law and Practice Quarterly*, vol. 2, pp. 138–48.

### ***Mutuality of obligation***

3.81 As discussed in the income tax section above, one issue that seems to be of greater significance in the context of employment law than for tax purposes is that of mutual obligation. According to the employment law cases, there must be an irreducible minimum of obligation on each side to create a contract of service: some kind of remuneration on the part of the employer and some obligation to provide his own work on the part of the employee.<sup>101</sup> As we have seen, for tax purposes there is a concern only with the relationship at the time the payment potentially subject to tax is made. Provided each separate engagement is an employment (that is, for that engagement there was an obligation to pay on one side and to provide service on the other),<sup>102</sup> there is no need to look further to see whether there is an umbrella employment. In theory, National Insurance will normally follow taxation, although it has been suggested above that mutuality might also be important in relation to National Insurance.<sup>103</sup>

3.82 In addition, there are statutory provisions that result in agency workers being subject to income tax and National Insurance as if they were employees (discussed further in Chapter 4), but that do not apply for employment protection purposes. The Employment Appeal Tribunal held, in *Wickens v Champion Employment Agency Ltd*,<sup>104</sup> that, although tax and National Insurance were deducted under these statutory rules, temporaries in an employment agency were not employed for the purposes of the Employment Protection (Consolidation) Act 1978. There was no obligation on either side to accept or offer bookings and there was not ‘a relationship that had the elements of continuity and care associated with the relationship created by a contract of employment’.

3.83 This mutuality factor is of critical importance for non-standard workers such as casual workers, homeworkers and agency workers. These workers may be classified as employees for tax and National Insurance purposes and indeed be employees in respect of each engagement for employment law purposes. However, they may still not be able to show sufficient mutuality to cover the periods in between periods of work and so satisfy the continuity of employment requirements for employment protection purposes. As the DTI employment status report points out, the interaction of the mutuality rule and the rules that require continuity of employment

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<sup>101</sup> *Ready-Mixed Concrete (South East) Ltd v Minister of Pensions and National Insurance* [1968] 2 QB 497; *Nethermere (St Neots) Ltd v Taverna and Gardiner* [1984] IRLR 240; *O’Kelly v Trusthouse Forte plc* [1983] IRLR 369; *Clark v Oxfordshire Health Authority* [1998] IRLR 125 CA – ‘bank nurses’ were held not to be employees due to lack of mutuality of obligation; *Carmichael v National Power plc*, fn. 32 above.

<sup>102</sup> ESM 1071.

<sup>103</sup> See paras 3.66 and 3.67 above.

<sup>104</sup> [1984] ICR 365; see also *McMeechan v Secretary of State for Employment* [1997] IRLR 353 (a specific engagement with an agency held to be an employment notwithstanding label to the contrary).

for there to be an entitlement to certain benefits (such as statutory sick pay, statutory maternity pay and statutory redundancy payments) may deny workers, who have been taxed and have paid National Insurance as employees, various aspects of employment protection and benefit entitlement.<sup>105</sup>

3.84 Whilst this may well be perceived as unfair, it is not so much the consequence of inconsistency between tax, National Insurance and employment classification rules as of the rules requiring various levels of continuous employment as a basis for entitlement. The different tribunals are not disagreeing in their analysis of a particular contract but are focusing on engagements at different levels.<sup>106</sup>

3.85 The mutuality of obligation principle was discussed in *Carmichael v National Power plc*. Two guides at Blyth Power Stations were offered work when there was work for them to do, normally accepted it and were paid by the hour. They were held by the Court of Appeal, overturning the decision of the industrial tribunal, to be employed under a contract of service and therefore entitled to written particulars of the terms of their employment under the Employment Protection (Consolidation) Act 1978. The fact that the guides had had employee NICs deducted from their pay was one (small) factor that was weighed in the balance. For a time, this looked like a chink in the mutuality principle that might help casual workers. The House of Lords, however, allowed the employer's appeal and upheld the decision of the industrial tribunal that the guides were not in any contractual relationship with National Power when they were not working.<sup>107</sup>

3.86 Their Lordships considered that the Court of Appeal had placed too much emphasis on the construction of the documents between the parties (a question of law) and not enough on the surrounding circumstances (a question of fact for the tribunal).<sup>108</sup> Thus the Court of Appeal had been wrong to overturn the decision of the tribunal. In any event, on the documents, their Lordships considered that there was an absence of mutual obligation. Lord Hoffmann was of the view that the guides may well have been employed whilst actually performing the work, but this was not enough to give them the entitlement they sought.

3.87 By contrast, in a recent Court of Appeal case, *Express and Echo Publications Limited v Tanton*,<sup>109</sup> where a contract contained a clause permitting a worker to substitute another for him, it was held that, as a matter of law, the relationship between the worker and the person for whom he worked was not one of employment. This was a case where an employee had been made redundant and then very soon

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<sup>105</sup> The DTI employment status report, fn. 23 Introduction above, at para. 2.4.

<sup>106</sup> For practical purposes, the employment law problem can sometimes be tackled by statutory techniques for extending qualifying periods – see Collins 2000, fn. 11 Chapter 1 above, and para. 4.55 below.

<sup>107</sup> *Carmichael v National Power plc*, fn. 32 above.

<sup>108</sup> On this distinction, see further paras 3.102 *et seq.* below.

<sup>109</sup> Fn. 59 above.

afterwards entered into a new agreement containing this clause. The court considered that the issue was a question of law because it related to the question of whether the clause in the written contract was inherently inconsistent with a contract of employment. This may give welcome guidance. On the other hand, it is being argued in some quarters that ‘*Echo*’ clauses will become a simple way of avoiding employment status, especially where the new personal service company provisions would otherwise apply.<sup>110</sup> This seems unlikely to be effective. The tribunal in *Echo* had expressly held that the clause was not a sham and Mr Tanton had in fact provided a substitute driver when he was ill. Client/employers may not be ready to accept this type of clause as a device, and evidence that it was purely formal and that substitution was not *actually* permitted would destroy its effectiveness.<sup>111</sup>

### ***Relationship between employment law and tax and National Insurance***

3.88 The employment tribunals have sometimes expressly addressed the question of tax and National Insurance, but with mixed and inconclusive results. They do appear to have cited to them some of the major tax cases, especially, recently, *Hall v Lorimer*.<sup>112</sup> The case of *Young & Woods Ltd v West*<sup>113</sup> is sometimes cited as authority that there is one single test to be employed in relation to all matters. In that case, West was offered a ‘choice’ of status by the company to which he was supplying services. The company said he could be an employee or an independent contractor. As an employee he would be paid net of tax, but as a self-employed person he would be paid gross. If self-employed, however, he would be the first to go if there were redundancies. West ‘elected’ to be self-employed. Nevertheless, when the company subsequently dispensed with his services, he successfully claimed to be entitled to claim unfair dismissal. The Court of Appeal took the view that the true legal position for all purposes was that West was an employee and that the Inland Revenue had a statutory duty to tax him retrospectively as an employee.<sup>114</sup> It was not a matter on which the parties had a choice or election, but of the true legal relationship between the parties.

3.89 Any other decision in the *Young* case would have meant that effectively the parties could have contracted out of the employment protection legislation *and* opted into what the parties perceived to be fiscal advantages. The Court distinguished the

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<sup>110</sup> See, for example, P. Vaines, ‘Taxing matters’, (1999) *New Law Journal*, 5 November.

<sup>111</sup> There was some evidence in the *Echo* case itself that substitution was not normally permitted but this evidence had not been presented to the industrial tribunal, the tribunal of fact, and so was not admissible.

<sup>112</sup> Fn. 39 above.

<sup>113</sup> [1980] IRLR 201 CA.

<sup>114</sup> The *Young* case assumed that, once the employment status of the worker had been decided for employment protection purposes, the Inland Revenue would seek to rectify the tax position, although it may well not be a simple matter to do this – see Appendix below at fn. 25.

earlier case of *Massey v Crown Insurance Co.*<sup>115</sup> where an insurance agent had entered into an agreement accepted by the Inland Revenue as resulting in his being self-employed and then attempted to claim unfair dismissal. There, Lord Denning had stated:

‘If the parties deliberately arrange to be self-employed to obtain tax benefits, that is strong evidence that that is the real relationship ... having made his bed as self-employed he must lie on it.’

3.90 Again, this supports consistency but takes more account of the previous arrangement with the Inland Revenue. This was on the basis that, where the status question is ambiguous, the label the parties use may be of significance in determining the relationship. The *Young* case confirmed that the label used by the parties might be relevant when deciding the parties’ intention, but could not alter their true legal relationship if other factors pointed elsewhere. Neither case envisaged that status for tax and National Insurance purposes could differ from that for employment law purposes.

3.91 Other employment law cases have been less concerned with consistency. In *O’Kelly v Trusthouse Forte plc*,<sup>116</sup> for example, the taxpayers, who were ‘regular casuals’ in the catering industry, paid tax and National Insurance as employees. That was held by the industrial tribunal not to be indicative, of itself, of the legal basis of the relationship. Ackner LJ accepted this without comment in the Court of Appeal and went on to agree with the industrial tribunal that there was no contract of employment. There was no recommendation that the tax position should be reviewed: this was simply not mentioned and it is not known what occurred in practice.

3.92 In *Lane v Shire Roofing C (Oxford) Ltd*,<sup>117</sup> a builder had been paying tax as self-employed but was held to be an employee for health and safety legislation purposes. This was considered to be a matter of public interest. The policy of the law was to make the employer liable for safety. The fact that there were tax and other advantages in avoiding the employee label did not remove the policy reasons in the safety-at-work field for ensuring that ‘the law properly discriminated between employees and independent contractors’.

3.93 The *Lane* case must be contrasted with an earlier Court of Appeal case, *Calder v H Kitson Vickers Ltd*.<sup>118</sup> In that case, Ralph Gibson LJ stated that

‘... a conclusion on status is a decision of fact upon all the relevant factors. But the decision does not depend upon the circumstances in which the question is raised, that

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<sup>115</sup> [1978] IRLR 31, followed in the tax case of *Barnett v Brabyn*, fn. 4 above, on the relevance of labels.

<sup>116</sup> Fn. 45 above.

<sup>117</sup> [1995] IRLR 493.

<sup>118</sup> [1988] ICR 232.

is to say, for example, whether it is a claim for damages for personal injury or an issue as to the obligation to deduct National Insurance contributions.’

It is notable, however, that this was not an employment law but an insurance case. There seems to be a greater inclination amongst the judges to classify status in a purposive way in the employment and health-and-safety-at-work fields than elsewhere.

### ***Owner-controlled companies***

3.94 The Employment Appeal Tribunal (EAT) in *Catamaran Cruisers Case Ltd v Williams*<sup>119</sup> did not appear concerned with this issue of consistency. In that case, the worker, Williams, set up his own limited company and supplied his services through this intermediary, a common practice in some industries. This was prior to the introduction of the legislation on personal service intermediaries.<sup>120</sup> If the company truly existed and entered into the contract to supply the services, then this was normally accepted by the Inland Revenue as effective for tax purposes.<sup>121</sup> However, in this case, Williams wanted both the tax and National Insurance advantages of this arrangement and employment protection. He brought a case for unfair dismissal on the ground that he was an employee. The EAT found that the industrial tribunal had not erred in finding that Williams was an employee, despite the existence of the limited liability company.

3.95 The EAT accepted that a company has a separate legal personality and did not hold that this company was a sham. They noted that payments had been made gross to the company (without deduction of tax) and did not criticise this arrangement. This seems to have left the company intact for tax purposes as well as company law purposes in accordance with cases such as *Lee v Lee's Air Farming Ltd*.<sup>122</sup> Williams appeared to succeed in eating his cake and keeping it, in the way condemned by Denning in *Massey*, cited above. The personal service intermediaries legislation will have the effect of ensuring that, usually, such a person is taxed as if he were receiving Schedule E payments in such a situation. In a case like *Catamaran*, therefore, on the face of it, it looks as though this new legislation might achieve a result consistent with the approach of the employment tribunal, but this outcome will not be certain.

3.96 The problem is that the personal service intermediaries legislation itself does not affect employment law at all. Unlike the original proposals, the final legislation does little to encourage a move to direct labour, and the government seems to have no intention of reviewing the impact of this legislation on employment law.<sup>123</sup> Therefore

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<sup>119</sup> [1994] IRLR 389.

<sup>120</sup> Discussed in Chapter 4 below.

<sup>121</sup> Inland Revenue Decision 4 (February 1992).

<sup>122</sup> Fn. 90 above.

<sup>123</sup> See paras 4.92–4.95 below.

it is a question of fact in each case whether the employment tribunal considers there to be an employment despite the existence of a company. This gives no certainty to workers, caught under the new tax and legislation, that they will obtain employment protection rights. Of course, the answer for them is to insist on direct employment, if they can, and the removal of the tax and NICs incentives to do otherwise may assist with this, but client/employers may continue to insist on working through intermediary companies, as discussed in Chapter 4 below. Part of their reason for doing this may be to deny the worker employment protection rights. It remains to be seen whether the employment tribunals and higher courts will take the new tax legislation into account when considering employment law issues. It is unfortunate that the government has not reviewed the employment law issues concerning intermediaries at the same time as legislating on the tax and NICs aspects.

3.97 The question of whether a controlling shareholder of a company can also be an employee has arisen recently in a different context: in connection with rights under the Employment Rights Act 1966 (ERA) to collect statutory redundancy and other payments on the insolvency of that company. In *Buchan and Ivey v Secretary of State for Employment*,<sup>124</sup> the EAT decided that a controlling shareholder could not be an employee for that purpose because he controlled his own dismissal from the company. This decision was not followed in the subsequent case of *Secretary of State for Trade and Industry v Bottrill*,<sup>125</sup> where the EAT held that whether a sole shareholder of a company was also its employee for this purpose was purely a question of fact.<sup>126</sup> In that case, it was held that the industrial tribunal had not erred in holding the claimant to be an employee.

3.98 The Court of Appeal upheld the EAT's decision in *Bottrill*<sup>127</sup> and cast doubt on the reasoning in *Buchan*. In its view, control of shareholder voting by a person should not necessarily preclude that person having the status of employee. First, shareholder control does not necessarily give immediate control of management decisions over dismissal. Second, the Court of Appeal disliked the attempt to give a special meaning to the word employee for employment protection purposes that it does not have under general law or in other contexts. It had been suggested to the Court of Appeal that its guidance was needed in order to provide a clear and simple test of when ERA applied.<sup>128</sup> It stated that it felt unable to give this guidance as a question of law, deciding that the general definition of employee applied and could only be decided by having regard to all the relevant facts.

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<sup>124</sup> [1997] BCC 145 (EAT).

<sup>125</sup> [1998] IRLR 120.

<sup>126</sup> Similarly in *Fleming v Secretary of State for Trade and Industry* [1997] IRLR 682.

<sup>127</sup> [1999] BCC 177.

<sup>128</sup> In the *Buchan* case, the EAT expressly hoped for guidance from an appeal court, saying 'These cases are increasingly common. If we have misinterpreted the law it would help us, the industrial tribunals and those responsible for giving advice to have a corrective ruling as soon as possible from the Court of Appeal.'

3.99 Once again, this group of cases shows both the difficulties of a general and fact-based definition of employee which gives rise to uncertainty and the problem of fixed or rigid definitions as attempted in *Buchan*, which could result in injustice in some circumstances and manipulation in others. In terms of the justice of the case, in *Bottrill* the Court of Appeal pointed out that Mr Bottrill had been paying NICs. Thus to deprive him of his claims under ERA ‘could be to deprive unjustly that individual of the benefits to which he could properly expect to be entitled after he and his “employer” had made the appropriate contributions’.

3.100 The DSS has stated that there is no injustice in such a case because statutory redundancy pay is not a contributory benefit (although met from the National Insurance Fund since 1990).<sup>129</sup> Payment for redundancy is contingent on being an employee, but not on payment of Class 1 NICs. Sometimes, directors of companies of which they are sole shareholders had been found to be self-employed and so not entitled to redundancy pay as described above, but not entitled to claim a refund of primary or secondary Class 1 NICs because the Inland Revenue/Contributions Agency still regarded them as employed earners. Despite the explanation in the DSS report, a mismatch between the definition of employee for employment protection purposes and National Insurance contribution purposes clearly gives rise to a sense of injustice. Those paying NICs consider that this should give them a right to social security protection and do not draw nice lines in their minds between the complexities of entitlement to contributory and non-contributory benefits. A system that relies on such fine distinctions will cause confusion and not command respect or support.

3.101 *Bottrill* was followed by the EAT in *Smith v Secretary of State for Trade and Industry*.<sup>130</sup> The court in *Smith* found that the employment tribunal had erred in law in deciding that an applicant for a redundancy payment was not an employee by treating the fact that the applicant was a controlling shareholder as *determinative* of the issue and by not taking proper account of the fact that tax and NICs were paid on an employee basis. Thus, though the Court of Appeal in *Bottrill* was adamant that the definition of employee was a question of fact, it has actually created a point of law in a negative sense. If the tribunal applies a rule that a controlling shareholder cannot be an employee, then it can be reversed. This does not give complete certainty, but does provide important guidance and, as such, is a useful development.

### ***Law and fact***

3.102 In many of the above cases, there was an issue about the jurisdiction of the court to hear an appeal from the industrial or employment tribunal due to the problem of whether employment status was a question of law or fact. There is a strong tendency in the employment law cases, as in the area of tax and National Insurance, to resist finding that status is a question of law and to consider that classification is

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<sup>129</sup> The DSS 1994 report, fn. 80 above, at p. 87.

<sup>130</sup> [2000] ICR 69.

largely a question of fact. The recent cases of *Carmichael* and *Bottrill* have reinforced this approach, but, at the same time, *Bottrill*, together with other cases such as *Hall v Lorimer*, has shown how a mixed question of law and fact can evolve from this process.

3.103 The Privy Council has put forward the following view of the case law:

‘Whether or not a person is employed under a contract of service is often said in the authorities to be a mixed question of fact and law. Exceptionally, if the relationship is dependent solely upon the true construction of a written document, it is regarded as a question of law: see *Davies v Presbyterian Church of Wales*,<sup>131</sup> but where, as here, the relationship has to be determined by an investigation and evaluation of the factual circumstances in which work is performed, it must now be taken to be firmly established that the question of whether or not the work was performed in the capacity of an employee or as an independent contractor is to be regarded by an appellate court as a question of fact to be determined by the trial court.’<sup>132</sup>

3.104 Lord Hoffmann explained the reasons for this distinction between written documents and other forms of evidence in the *Carmichael* case.<sup>133</sup> It was considered essential for the development of English commercial law that questions of construction of standard commercial documents went to judges as a question of law in order to create precedent and certainty. One might argue that exactly the same considerations give rise to the need for status questions to be questions of law. Yet Lord Hoffmann considered that the Court of Appeal’s attempt to deal with the contract in *Carmichael* as a purely written contract in order to achieve this went too far. The rule about construction of documents being a question of law can only apply, he stated, where the parties intend all the terms of their contract (apart from any implied by law) to be in a document or documents. That was not the case in the circumstances of the *Carmichael* case.

3.105 This can limit the extent to which appeals will be entertained. Where there is no document, or the document does not contain all the terms of the contract (which, following the *Carmichael* approach, it seems it rarely will), it will be necessary to show that the fact-finding tribunal has come to a perverse decision if it is to be overruled. Yet, as noted above, judges seem to have an ability to find a point of law if they desire to do so, even if only in the negative sense of finding that a particular factor is not determinative of the issue, which is another way of ensuring that this factor is not given undue weight. The approach in the *Smith* case is welcome and shows that, though the definition of employee remains a question of fact, it is mixed with questions of law. Properly developed, these legal pointers could give important guidance in the future.

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<sup>131</sup> [1986] 1 All ER 705.

<sup>132</sup> *Lee Ting Sang v Chung Chi-Keung*, fn. 2 above.

<sup>133</sup> Fn. 32 above.

### *Classification case law and value added tax (VAT)*

3.106 There have been a number of cases on status heard by the VAT tribunals. For various reasons, VAT may be another factor in pushing someone towards or against employed status.<sup>134</sup>

3.107 The question of status arises in VAT cases because VAT is charged on taxable supplies in the course or furtherance of a business.<sup>135</sup> It is therefore necessary to decide whether the supply is made in the course of a business or as an employee. This stems from the Sixth Directive on VAT,<sup>136</sup> Article 4 of which states that a 'taxable person' is a person who independently carries out in any place any economic activity (as defined in the directive). The article defines 'independently' to exclude employed and other persons from the tax in so far as they are bound to an employer by a contract of employment or by any other legalities creating the relationship of employer and employee as regards working conditions, remuneration and the employer's liability.

3.108 The general law test of whether there is a contract for services or a contract of service is applied in VAT cases, which have imported the *Market Investigations* test discussed above.<sup>137</sup> A recent example of this can be found in *C&E Commissioners v Hodges*,<sup>138</sup> in which Moss J applied reasoning and cases from general law, many from employment law. He reached the conclusion that, first, the question of employment status was a question of fact and, second, that the VAT tribunal had made errors of law which tainted its decision. The matter was therefore remitted to the tribunal.

3.109 The employment status question may not, however, determine the VAT issue in every case. There is a further question, which is whether the services are supplied to the customer by the individual service supplier or whether the supply is actually made by another business, for whom the individual service supplier is acting as an agent.<sup>139</sup> In the latter case, it would be that other business that would be making the taxable supply. The two questions of employment status and who makes the supply sometimes seem to become entangled in the cases. These two layers of questions are apparent, for example, in a number of cases concerning agency workers<sup>140</sup> and hairdressers.<sup>141</sup> It is clearly relevant to ask whether the individual service supplier is an employee or self-employed, but not conclusive of the ultimate VAT position. Even if they are self-employed and below the VAT registration threshold, they may be providing services on behalf of the other business which is above the threshold, so that VAT is payable.

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<sup>134</sup> See Appendix to this paper.

<sup>135</sup> For further details, see Appendix to this paper.

<sup>136</sup> EC Council Directive 77/388.

<sup>137</sup> *New Way School of Motoring Ltd v Customs and Excise Comrs* 1979 VATTR 57.

<sup>138</sup> [2000] STC 262.

<sup>139</sup> *Tiley and Collison*, fn. 7 above, at para. 64.19.

<sup>140</sup> For example, *C&E Commissioners v Reed Personnel Services Ltd* [1995] STC 588.

<sup>141</sup> *C&E Commissioners v MacHenry's (Hairdressers) Ltd* [1993] STC 170.

3.110 This is often the issue in relation to hairdressers, where the salon is registered and will have to charge VAT if it is making the supply. If a self-employed hairdresser working within the salon, but as a separate business, makes the supply direct, there will usually be no VAT because the individual hairdresser is below the registration threshold. Since the customer will be a private individual, not a business, so that the VAT cannot be recouped in any way, this becomes a significant issue. Some of the cases on hairdressers have found it unnecessary to deal with the issue of whether there is a contract for services or a contract of service at all.<sup>142</sup> Others have engaged with the question of whether the hairdressers are self-employed or not and applied the familiar, general tests.<sup>143</sup> The end result may be, however, that the hairdresser is found to be self-employed for income tax purposes, but the salon is still liable for VAT in relation to her services because the customers are held to have contracted with the salon proprietor rather than with the individual hairdresser.<sup>144</sup> This will no doubt seem confusing to those involved, but does not mean that the tribunals are applying different tests of employment status, since the question being addressed is different in each case.

3.111 Recent cases on sub-postmasters have also discussed employment status, this time in a more direct way than in the hairdressing and agency cases. In *Rickarby v Customs and Excise Commissioners*,<sup>145</sup> a sub-postmaster who was treated as an employee for income tax and NICs purposes was found to be an employee for VAT purposes also and therefore not required to register for VAT. At least this showed a desire for consistency for tax purposes. Unfortunately, though, there seems to be some inconsistency between the employment law position on sub-postmasters and VAT. The EAT held, in *Hitchcock v Post Office*,<sup>146</sup> for example, that a sub-postmaster was not an employee for the purposes of claiming unfair dismissal. Although there was a substantial measure of control relating to the conduct of Post Office business, the other circumstances, including the fact that he provided his own premises and could delegate his duties to others, showed that he was not an employee. The tribunal found the administrative arrangements made by Customs and Excise in relation to VAT and the income tax position in the case of no 'assistance at all'. This is an unhelpful approach on the part of the tribunal when the case law applied in each case, and therefore the relevant factors, are supposed to be the same. It may, in part, be explained by the fact that the sub-postmaster had formed a limited company to receive his income from the sub-post office. It was agreed by both sides to ignore the existence of the company for the purposes of the case, but its existence obviously had an impact on the tax situation.

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<sup>142</sup> *Customs and Excise Commissioners v Jane Montgomery (Hair Stylists) Ltd* [1994] STC 256.

<sup>143</sup> *MacHenry*, fn. 141 above.

<sup>144</sup> *D L Freer*, LON/91/1069Y (7648), cited in A. Dolton and R. Wareham, *Tolley's VAT Cases 2000*, (2000) Tolley, London, at para. 55.198.

<sup>145</sup> [1973] VATTR 186 (44).

<sup>146</sup> EAT [1980] ICR 100.

3.112 Litigation continues on the precise status of sub-postmasters. It was held in *H&V Patel*<sup>147</sup> that a sub-postmaster is an employee of Post Office Counters Limited for VAT purposes and so does not make supplies in his own right when acting as such.<sup>148</sup> Therefore, in this case, a partnership running a retail news agency business could not reclaim input tax on a payment made to the Post Office when taking on the sub-post office. *Hitchcock* was distinguished on the facts, the *Patel* decision being based heavily on the degree of control over all aspects of the post office business retained by the Post Office. This was despite the fact that the contract stated expressly that it was a contract for services. Other recent cases, though, have not only treated sub-postmasters as not being employees for employment law purposes, but found that they are not helped by the extended definitions in discrimination legislation which cover those engaged under a contract to do work personally.<sup>149</sup> This is because they have no obligation to do the work personally and do have the power to delegate.

3.113 This is hard to reconcile with the VAT cases. Of course, each case is decided on its own facts, but we can see from the unwillingness of the EAT in *Hitchcock* to look at VAT and the willingness of that tribunal to ignore the existence of an intermediary company that the different tribunals may come to a different conclusion on the same facts, even though the question asked is supposed to be the same one in each case. It seems that, whilst control is of vital importance in the VAT cases, the lack of obligation to do the work personally is more important in the employment law and discrimination cases. This can be explained on the basis that VAT is concerned with the question of identifying an independent business making a taxable supply, so that control is a dominant factor, whilst employment and discrimination law depend upon a personal relationship.

3.114 Although the different perspectives of the two tribunals can be understood, they do purport to be applying the same tests, and therefore this is a confusing situation which highlights the unwillingness of tribunals in one area to be bound by those in another. The case law may be to the detriment of the sub-postmaster, who cannot obtain employment protection, but also cannot treat the sub-post office as part of his business for VAT purposes. The law can hardly be said to be clear, or self-evidently just, in such a situation.

## **Other areas of law**

3.115 Status issues arise in many areas of law not discussed here, including insurance, health and safety, personal injury cases and tort. In each type of case, it may be argued that there are different policy considerations: in particular, third parties are

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<sup>147</sup> LON/94/2821 (14956), cited in *Tolley's VAT Cases*, fn. 144 above, at para. 7.90.

<sup>148</sup> See also *John Pugh and Helen Pugh* LON/95/654 16034.

<sup>149</sup> *Sheehan v Post Office Counters Ltd* [1999] ICR 734 (EAT) (no jurisdiction under Disability Discrimination Act 1995); *Tanna v Post Office* [1981] ICR 374 (Race Relations Act 1976).

involved in many of these issues but are not concerned with employment, tax or National Insurance law.<sup>150</sup> It may be thought that total alignment of approach across this wide range of cases is an impossible objective, although once again, in theory, they all have the same case law starting-point to the extent that they are based on whether there is a contract of service. If consistency of approach is not possible, however, then it does seem reasonable that the different policy considerations that will be taken into account should be express and transparent and not a matter of guesswork for litigants.

### **Chapter conclusions – the future of the case law**

3.116 At first sight, the case law tests for determining the status of workers might seem to be outdated and too uncertain to be of real value. So, for example, the Professional Contractors Group (PCG) argues that<sup>151</sup> ‘the “self-employment tests” were not designed for businesses in the knowledge based sector but are more suitable for manual or skill-based traditional businesses’. This may not take fully into account the flexibility of case law and its ability to adapt to changing conditions. It has been suggested that a simpler, clearer test is needed, but no one has been able to suggest a test that falls within this description.<sup>152</sup> The variety of working patterns that exists makes it impossible to devise a simple test.

3.117 Tests such as the number of clients/employers for whom work is done would be easily manipulated if they were stated categorically and rigidly. Thus any statutory test would need to list factors or badges to be considered in much the same way as the case law does. It is doubtful whether statutory weights could be attached to such factors, and so it may be questioned whether anything would be achieved by any such statutory listing. The Tax Law Rewrite Team has concluded that any detailed statutory definition would give no greater certainty than exists now.<sup>153</sup>

3.118 It is significant that no simple statutory test has been devised in other jurisdictions we have examined. Most of these countries have a list of factors similar to that in the UK. Where countries do use statutory definitions of employees or disguised employees, they often utilise concepts such as dependence, entrepreneurship or running a business, which raise as many issues as does the use of the concept of a contract of service. Nevertheless, statutory clarification of definitions for some groups of non-standard workers of the type discussed in Chapter 2 can be helpful and has

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<sup>150</sup> Perrins, fn. 88 above, at para. A[9].

<sup>151</sup> *The Professional Contractors Group and Judicial Review Relating to IR35* – [www.pcgroup.org.uk/jr-background](http://www.pcgroup.org.uk/jr-background).

<sup>152</sup> See, for example, IOD paper 1998, fn. 17 Introduction above; E. Troup, *Financial Times*, 30 September 1999.

<sup>153</sup> Tax Law Rewrite, Exposure Draft 6, *Employment Income: Chargeability and Charge*, June 1999 – Commentary on clause 4.1.2.

been used in the UK and elsewhere.<sup>154</sup> The UK special cases are discussed in Chapter 4 below. ‘Safe harbours’ may also be created by legislation, which can shift the onus of proof and give a measure of certainty.

3.119 The value of the case law should not be underestimated. The courts have shown an ability to adapt to changing work conditions in cases such as *Market Investigations* and *Hall v Lorimer*. There is, however, considerable uncertainty at the margins about worker classification under the case law. In practice, the courts do give guidance and evolve points of law as discussed above. A greater willingness to admit to this and to express these points as creating a legal framework, even if only in the negative sense of deciding that certain factors are not determinative of the status of a worker, would be welcome.

3.120 It is not surprising that the Inland Revenue has not found it easy to draw up simple, yet comprehensive, guidance on the case law. The publication of the ESM is welcome, but a guidance booklet, more detailed than IR56 but less overwhelming than the ESM, would be desirable. Examples, as found in the IR35 guidance, would be welcome.

3.121 It can be confusing that, whilst the employment law, insurance, tort, income tax, VAT and National Insurance cases all appear to start at the same point and cite the same authorities, the different contexts in which they are heard seems to result in the development of subtly diverging case law. The assumptions and policy objectives of the different courts, whether they are express, as in some cases, or merely implicit, do appear to affect their decisions.

3.122 Two alternative developments could be helpful here. The House of Lords could spell out that status decisions based on the same general case law without statutory adaptation should not depend upon the circumstances, as has been suggested in the cases of *Calder* and *Bottrill* cited above. Alternatively, it could make an express statement that, even though the case law starting-point is the same in different areas of law, different policy considerations in those areas *may* affect the outcome of a case.

3.123 What is difficult to accept is the position we have now where there is lip-service paid to common principles but the application of them differs. The effects of this are masked by the emphasis of the courts on the role of fact in these cases. Status will always be a factual decision in part, but, as argued above, there are points of law involved upon which the courts should be prepared to give guidance. In practice, this is what is occurring, even though the courts sometimes seem to play down the role of points of law in this area.<sup>155</sup> Like the question of whether an activity is trading for tax

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<sup>154</sup> Extra-statutory concessions may also be used to give certain groups particular treatment – for example, ESC A1 in relation to expenses.

<sup>155</sup> This may be a deliberate attempt to reduce appeals for administrative reasons, but this may pay insufficient regard to the importance of guidance for the many more cases that do not reach the courts.

purposes, for example, the question of worker status is a mixed question of law and fact. It should be possible for the courts to develop their response to such mixed questions of law and fact so as to provide a legal framework, without encouraging an unmanageable level of appeals. Provision of an outline framework by the courts does not need to deprive the fact-finding tribunals of their important role but can give them much needed guidance. Such ‘points of law’ always have to be evaluated in the context of all the facts. A welcome development of this approach can be seen in the application of the *Bottrill* decision in the recent case of *Smith*.

3.124 It is also important that, where different conclusions appear to have been reached for tax and employment law purposes, but where in fact there are different issues being considered (for example, where for tax purposes what matters is status under a short-term contract, whilst for employment law purposes it is important to show a longer-term contract), this should be clearly analysed so that it is evident that the law is not confused.

3.125 Where there are existing differences because special statutory provisions apply in one area, but case law continues to apply in another, as with personal service companies, the justifications for these distinctions should be considered by government across departments. If there are different objectives, then this should be made clear. If there is no good reason for the difference, then alignment should be considered. The way forward may yet turn out to be different statutory definitions for different legal purposes in some cases to provide certainty and protection where needed, against a background of the flexibility of the general law.

3.126 Ideally, the guidance suggested above should cover other areas of law as well as tax and NICs. This should be a cross-departmental exercise, and areas of difference between the different types of classification should be explained as far as possible. Simply to state that there may be differences is to invite the view that the law is confused.

3.127 The case law tests have been given a central role under the personal service intermediaries legislation. The controversial nature of this legislation and the fact that litigation has been threatened do suggest that a great burden will be placed on the case law tests. It remains to be seen whether the courts will be able to meet the challenge of taking full account of the types of arrangement that those workers using intermediary companies are entering into, as well as giving concrete enough guidance to provide the commercial certainty needed by the sectors affected by these arrangements and the new legislation.

## **CHAPTER 4: SPECIAL CLASSIFICATION PROBLEMS AND LEGISLATIVE RESPONSES**

**This chapter examines particular types of worker for whom categorisation under existing case law is especially problematic. As we have seen in Chapter 2, workers in these ‘problem’ categories have grown in number over the last two decades and this development may continue. Examples are homeworkers, casual workers, agency workers and others supplying services through an intermediary, construction workers and entertainment workers.**

**In some, but not all, of these cases, the position is subject to express statutory provisions, some of which override or bypass the case law tests described in Chapter 3. Specific legislation and subcategories are suggested by some as a solution to the problems of uncertainty and inadequacy perceived to result from our current case law classifications. These existing special provisions may provide some guidance or raise questions on this point. They do not appear to remove definitional problems, though they may ease them.**

**These legislative provisions rarely apply for all purposes. This can increase the discrepancies between the tax, NICs and employment law positions of a particular type of worker. The extent to which alignment of these special provisions in different areas of law is desirable and feasible is also considered in this chapter.**

### **Types of legislative approach to the classification problem**

4.1 There are various legislative approaches to dealing with those falling in the ‘grey area’ of workers where classification as employed or self-employed is difficult.

- The workers may be treated as if they were employees for some or all purposes, regardless of their status under the case law (for example, agency workers).
- A group of workers may have a special procedure, such as deduction at source, or other set of rules, applied to them so that the question of employment status becomes less significant (for example, construction workers).
- A third approach, found in some modern employment legislation, is to bypass the concept of employee altogether and to extend provisions to ‘workers’, defined to cover all or some of those in the ‘grey area’.

Neither of the first two approaches wholly avoids the need to apply the case law tests initially, to see whether the worker does fall within the ‘grey area’ subject to these special rules, but they may assist with practical issues. The third approach is more radical but requires a definition of ‘worker’, which could be as problematic at the

boundaries as the definition of employee.<sup>1</sup> Whilst it may work in some situations, it may be too wide to be practical in others.

4.2 Sometimes these techniques are applied in one area of law without consideration of other areas. This can create distortions and confusion and increase costs. We have considered above the extent to which alignment of the rules for worker status definition in different areas of law is desirable and have suggested that complete alignment may not be feasible due to the different objectives of the law in different areas. We have suggested, however, that where there are differences, these should be transparent and made for clear policy reasons. Failure to look at tax, NICs and employment law together may result in confusion and even cases of injustice. An example of this may be found in the case of personal service companies. Taxpayers falling under this regime will be treated for tax and NICs purposes as if they were employees of their clients, but will gain no employee rights *vis-à-vis* those clients. This may well be perceived as being unfair.<sup>2</sup>

4.3 The Social Security (Categorisation of Earners) Regulations 1978 (CATs Regulations)<sup>3</sup> make provision for a number of groups to be classified as employed or self-employed earners for NICs purposes. These classifications (for example, in relation to examiners) are not adopted in any comparable tax or employment law legislation and the question arises as to whether this discrepancy is necessary to fulfil certain original policy objectives or for practical reasons. Even where there are similar regulations on categorisation (principally in relation to agency workers) for tax and NICs purposes, the wording is not always identical and can lead to discrepancies.

4.4 Other reports have noted that these discrepancies can cause confusion and a sense of injustice amongst groups whose status is ambiguous, particularly where such individuals are unable to utilise the potential tax and NICs advantages of self-employed status and receive no employment protection either.<sup>4</sup> This problem tends to be concentrated in sectors such as agency workers, homeworking, labour-only work and subcontracting.

4.5 As we saw in Chapter 3, it is still possible to be differently categorised for employment law on the one hand and tax and NICs purposes on the other under existing case law, even where there is no express legislation governing categorisation. Where there is legislation, it would be desirable for the effect of this on other areas of law to be considered and clarified and for the literature produced for guidance of taxpayers and others to make clear the relationship between the different rules.

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<sup>1</sup> The DTI employment status report, fn. 23 Introduction above.

<sup>2</sup> Redston, fn. 47 Chapter 3 above, confirms this is a perceived problem. On employment law rights, see Appendix to this paper.

<sup>3</sup> SI 1978/1689.

<sup>4</sup> The DTI employment status report, fn. 23 Introduction above, at para. 2.1.5; A. Corden, *Self-Employed People and National Insurance Contributions*, (1998) University of York, Social Policy Research Unit for the Department of Social Security, Report no. 84.

4.6 A worker will generally prefer alignment between tax and employment law where he is being classified as an employee for tax purposes. The reverse does not necessarily apply. Where employment law is extended to workers who are not employees, it is not always to their advantage to be classified as employees for tax and NICs purposes. For example, these workers will often have irregular work patterns that make them unlikely to be eligible for benefits because they do not satisfy requirements of continuity of contributions over a certain period.<sup>5</sup> The question of whether status definitions should be aligned for tax and National Insurance purposes on the one hand and employment law on the other is therefore complex.

4.7 Often, the individuals discussed in this chapter will have several different engagements over a year. Because the status determination rules apply on a contract-by-contract basis, they may end the year with a complicated mix of self-employed and employee earnings. Sometimes, the worker may be unaware of crossing the boundary into self-employment and the compliance aspects involved. The decision in *Hall v Lorimer*<sup>6</sup> helps such workers, in that their multiple engagements may be a factor in determining that they are self-employed, but the variety of contracts that they undertake may still result in a mix of treatments. As a result, these workers, who are often lower-paid and without access to good tax advice, may have very complex tax and National Insurance affairs which require settlement at the year-end and they may be left uncertain about their benefits and pensions position.

## **Special cases and tax and National Insurance legislative response**

### ***The construction industry***

4.8 The construction sector is a prime example of an industry where the simple operation of case law rules on employment status has been found to be inadequate and government has intervened to impose a special regime of deduction at source to reduce tax evasion. The Construction Industry Scheme (CIS) and its predecessors have a long history.<sup>7</sup> A full history and analysis of the scheme are outside the scope of this paper, but some issues arising from its development, relevant to classification, will be highlighted.

4.9 Throughout the history of the scheme, the Inland Revenue has had the co-operation of the larger employers who seek to comply with tax and NICs requirements but have found themselves undercut by less scrupulous competitors. The current scheme, introduced in August 1999, is now, however, subject to some criticism due to the level of compliance cost it imposes. The Inland Revenue has set up a joint working group with the Department of the Environment, Transport and the Regions

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<sup>5</sup> See Appendix to this paper.

<sup>6</sup> See Chapter 3 above.

<sup>7</sup> For the early history of this scheme, see: the Keith Report, fn. 19 Introduction above, vol. I, ch. 5; Harvey, fn. 21 Chapter 2 above, and papers cited there.

and all sections of the construction industry to examine ways in which the current scheme can be improved.<sup>8</sup>

4.10 There have been proposals for a system of deduction at source, based on the schemes devised for the construction industry, but applied more generally to casual workers in all sectors. Most notably, this was put forward by the Keith Committee in 1983.<sup>9</sup> More recently, Lord Grabiner QC considered whether this scheme should be extended to other areas but concluded that it was unlikely to be suitable for other sectors:

‘Few other industries rely on sub-contracted labour to such a large extent. It is hard to find other sectors where the regulatory burden on firms of a scheme requiring the deduction at source would not outweigh the tax compliance benefits.’<sup>10</sup>

4.11 The administrative and compliance cost issues raised by systems of deduction at source from workers who are not standard employees are not the subject of this paper but require further research.<sup>11</sup> It is clear that even the construction industry, which is particularly well suited to this system, as Lord Grabiner points out, finds the burden heavy, and it seems unlikely that government would wish to extend deduction at source whilst the CIS is itself under criticism and review.

4.12 On the other hand, arguably, a broader system of deduction at source would be fairer than one targeted only on one industry sector. As always in tax issues, so on this question, ‘a government must balance the objective of fairness with the goal of administrative feasibility’.<sup>12</sup> The new Australian PAYG system requires withholding tax to be deducted from any supplier of goods and service not able to provide an Australian Business Number and so is not industry-specific. It will be interesting to monitor the operation of this scheme.<sup>13</sup>

4.13 In 1972, provision was made for deduction of tax at source from payments made to certain subcontractors in the construction industry.<sup>14</sup> This was a reaction to increasing tax evasion by labour-only subcontractors hired under the system known as the ‘lump’. A contractor making payments to a subcontractor under a contract relating to construction operations had to deduct tax at the basic rate, unless that subcontractor

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<sup>8</sup> Inland Revenue Budget Press Release, *Construction Industry Scheme*, 21 March 2000, [2000] STI 415.

<sup>9</sup> The Keith Report, fn. 19 Introduction above, at vol. I, 6.3.4.

<sup>10</sup> Lord Grabiner QC, *The Informal Economy*, (2000) HM Treasury, London, at para. 4.10.

<sup>11</sup> For a survey, which concludes in favour of withholding taxes on business income to reduce tax evasion, see P. Soos, ‘Employed evasion and tax withholding: comparative study and analysis of the issues’, (1990) 24 *U.C. Davis Law Review* 107.

<sup>12</sup> Soos, fn. 11 above, at p. 192.

<sup>13</sup> See para. 3.14 above.

<sup>14</sup> Introduced in the Finance Act 1971 and subsequently amended on several occasions and consolidated in sections 559–567 ICTA 1988.

was an employee. The sum deducted was normally paid to the Revenue on a monthly basis. A subcontractor who had a satisfactory tax record might be given a certificate exempting him from deduction of tax. The system was subject to widespread evasion, despite various amendments to the legislation to improve it.<sup>15</sup>

4.14 The provisions were intended to apply only to those who were self-employed under the common law tests. Thus the aim was to create a new category of ‘self-employed’ subject to deduction at source. This was a specialised classification for some of the ‘grey area’ workers, as we have described them in this paper. In practice, many contractors operated the deduction system for their subcontractors without considering whether a worker was genuinely self-employed. Because basic rate tax was being deducted at source (unless the subcontractor had an exemption certificate), the loss to the Inland Revenue was arguably not very great. Subcontractors were taxed under Schedule D despite having tax deducted at source and so could deduct expenses under the rules for the self-employed, but many did not claim these deductions or even their personal allowances and so might even have been overtaxed.<sup>16</sup> This reduced the incentive to tax inspectors to argue that workers were employed. There was, however, a loss in NICs collected, since the subcontractors were treated as self-employed for this purpose.<sup>17</sup>

4.15 There were savings to ‘employers’ if they treated their workers as self-employed. Not only did they not have to pay NICs, but there were fewer other costs. Workers dealt with under the subcontractors’ scheme who should have been classified as employees lost out on benefits, training and employment law protection.<sup>18</sup> Larger contractors who wanted to employ their work-force directly complained that they were being undercut by those not following this course. By 1986/87, it was estimated that there were over 700,000 building workers being treated as self-employed for tax purposes.<sup>19</sup>

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<sup>15</sup> For example, exemption certificates were sold and contractors encountered difficulties in monitoring the validity of exemption certificates. For further examples, see the Keith Report, fn. 19 Introduction above, ch. 5.

<sup>16</sup> Harvey, fn. 21 Chapter 2 above, at p. 12 states that the Inland Revenue accepts that many individuals were overtaxed under this regime. It is also possible that some who did not claim expenses or allowances adopted this strategy deliberately since the deduction at source was at a lower rate than they would have had to pay on their top slice of income had they filled in a tax return and claimed allowances. Whether this resulted in over- or under-taxation depends on all the figures in each case.

<sup>17</sup> Moreover, the business requirement that the subcontractor had to meet to be eligible for a certificate entitling him to be paid gross proved capable of such wide interpretation that the scheme moved from a tax deduction scheme with limited exemptions to an exemption scheme with some limited tax deductions.

<sup>18</sup> Harvey, fn. 21 Chapter 2 above.

<sup>19</sup> UCATT, *The Construction Industry Transition to PAYE Employment*, (1998). This is a very high proportion of the total number of UK businesses – for details, see Chapter 2.

4.16 In 1994, building industry representatives approached the Inland Revenue and Contributions Agency with concerns about employment status.<sup>20</sup> Workers long regarded by the industry as self-employed had won cases before industrial tribunals on the basis that they were actually employees for employment law purposes, and the industry sought guidance for tax and NICs purposes. In co-operation with the larger organisations in the construction industry, the Inland Revenue and Contributions Agency decided to pursue more rigorously the question of whether workers were employed and so not eligible to be taxed as subcontractors.

4.17 A leaflet was issued in 1995 for guidance (IR148/CA69) and a helpline set up. Contractors were given until April 1997 to review the employment status of their workers. It was emphasised that employment status was not a matter of choice and that the same rules should be used in the construction industry as in all other industries to determine whether a worker was employed or self-employed. A *Tax Bulletin* article set out what contractors were expected to do and the tests they were to apply.<sup>21</sup>

4.18 At the same time as this initiative was taking place, it was announced that the CIS would be revised to reduce fraud in the industry.<sup>22</sup> The changes involved restriction of exemption certificates to more substantial businesses and the introduction of mandatory registration cards for all other subcontractors. (Construction workers supplying services to private householders or non-construction businesses spending no more than £250,000 p.a. on construction operations are not covered by these requirements.) Under the new system, anyone with no registration card can only be taken on as an employee; those with registration cards are paid under deduction of tax but otherwise treated as self-employed. Only those with exemption certificates can be paid gross. The reforms were introduced in the Finance Acts 1995 and 1996, but a long lead time had to be given to enable the industry to gear up to them. They eventually came into force in August 1999 after much consultation on the new systems and procedures and meeting with some resistance.<sup>23</sup>

4.19 The problems encountered were in part administrative: the need to ensure that the appropriate certificates and cards were issued before the start of the new scheme (problems were reported with supply) and the requirement that certain businesses with exemption certificates present their card showing their photograph in person, for example.<sup>24</sup>

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<sup>20</sup> Inland Revenue 28 *Tax Bulletin* April 1997, p. 405.

<sup>21</sup> *Tax Bulletin*, fn. 20 above.

<sup>22</sup> Inland Revenue Budget Press Release, Rev 38, 28 November 1995.

<sup>23</sup> See, for example, Association of Tax Technicians, *New Construction Industry Legislation Causes Concern*, 23 February 1999, [1999] STI 341 (hereafter ATT); Association of Chartered Certified Accountants, *Construction Industry Faces Tax Nightmare*, 1 March 1999, [1999] STI 370 (hereafter ACCA).

<sup>24</sup> ACCA, fn. 23 above.

4.20 There were also problems of substance, some of which have already been met by amendments to the scheme, but others remain bones of contention.<sup>25</sup> The new scheme imposes stringent requirements, including a turnover requirement, for businesses to be eligible for an exemption certificate. This is intended to prevent the situation that arose under the old scheme, when exemption certificates were very widely available. It has been criticised as setting the turnover level too high, however, so that a person working on his own will rarely be able to obtain exemption. He may have to pay for assistance or other expenses from pay after deduction of tax and this could result in serious cash-flow problems. The increased turnover from having help may eventually help him to obtain an exemption certificate, but firms require a trading history in order to obtain exemption and so could experience cash-flow difficulties due to deduction of tax at source just as they start out – in any event a difficult time.

4.21 These objections have been met in part by changes to the scheme. These reduce paperwork, reduce the threshold for obtaining a certificate which does not have to be presented in person and, from 6 April 2000, reduce the rate of deduction from net payment after deduction of materials from 23 per cent to 18 per cent.<sup>26</sup> This last change should help with cash-flow problems and ensure that personal allowances are taken into account, bringing the amount deducted closer to the actual liability of subcontractors than the previous deduction of basic rate tax. Nevertheless, settlement will be necessary at the year-end and the scheme is very complex to operate and administer, with legislation and guidance running to very many pages.

4.22 In the run-up to the introduction of the new scheme, many workers were reclassified as employees, though policing the new approach has not proved easy. Contractors on very tight margins are fearful of being undercut by competitors who continue to treat their workers as self-employed. The Inland Revenue experienced lack of audit resources and had to rely on competitors in the industry to report on other firms that did not apply the rules. Some building workers set up intermediary companies and partnerships. These now fall subject to the personal service company rules discussed below. The interaction between these two sets of rules is complex and this route will no doubt be discouraged by the IR35 legislation.<sup>27</sup> Some contractors began to use ‘internal agencies’ under their control to supply themselves with labour. The 1998 Finance Act contained provisions to prevent this by applying the normal

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<sup>25</sup> ATT, fn. 23 above.

<sup>26</sup> Inland Revenue Press Release, 25 February 2000, [2000] STI 211; Inland Revenue Budget Press Release, 21 March 2000, [2000] STI 415. Further relaxations and reduction of costs through use of e-business were announced in the November 2000 Pre-Budget Report, IR6, 8 November 2000.

<sup>27</sup> Redston, fn. 47 Chapter 3 above, at p. 373 explains the cash-flow problems that may result from falling within both the new subcontractor regime and the IR35 legislation. The Inland Revenue is reviewing this.

agency rules to construction workers, so that PAYE must be operated under these arrangements.<sup>28</sup>

4.23 Despite the difficulties, the reclassification scheme had some success. By 1997, 200,000 workers in the construction industry had been reclassified as employees.<sup>29</sup> The Inland Revenue and Contributions Agency issued a joint Press Release in September 1997 indicating that the number of audit visits to construction firms would be increased to ensure that status reviews were undertaken.<sup>30</sup> In addition, by March 2000, 50,000 businesses were registered with the Inland Revenue of which it had previously been unaware.<sup>31</sup> Therefore the scheme appears to be tackling evasion.

4.24 Nevertheless, there are some signs that, as the system settles down, there may still be a tendency for some contractors to use the registration scheme as a substitute for applying PAYE where workers are in fact employees. In a paper by the Union of Construction, Allied Trades and Technicians (UCATT), it is argued that some of the very large number of workers (800,000) who now hold registration cards should be classified as employees.<sup>32</sup> There are no conditions for holding a registration card, so that registration does not filter out those who should properly be treated as employees under the case law. UCATT points to indications in the statistics that the move from self-employment to direct labour has slowed down or slightly reversed since the introduction of the new scheme. For example, its paper comments that the latest Labour Force Survey *Quarterly Supplement* shows an upward trend of self-employment in the construction sector for the first quarter of 2000.<sup>33</sup> The data are not yet conclusive but will need to be monitored.

4.25 It is clear from the history of the CIS that such a scheme is not without difficulty. It would be very difficult to apply in a sector that did not have both strong union and industry representative bodies and it might not be worth while to invest the work, effort and political capital necessary to create and enforce such a scheme in a smaller sector. Applying such a scheme across all sectors might have an appeal in terms of horizontal equity, but the administrative burden and compliance costs would

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<sup>28</sup> Sections 55–56 and Schedule 8 of the Finance Act 1998.

<sup>29</sup> UCATT, *Response to the Inland Revenue Proposal for Simplifying National Insurance Contributions for Employers*, 2000 (supplied to the author by UCATT) (hereafter UCATT 2000).

<sup>30</sup> Inland Revenue Press Release 101/97, 25 September 1997.

<sup>31</sup> Inland Revenue Budget Press Release, 21 March 2000, fn. 26 above.

<sup>32</sup> UCATT 2000, fn. 29 above.

<sup>33</sup> Labour Force Survey, *Quarterly Supplement*, 'Employees and self-employed by industry sector', August 2000, Table 19. The paper also cites evidence of a flattening-off of the move towards employment status from the Construction Industry Training Board, *Levy Assessment Consultation Brief*, May 2000 and the DETR, *State of the Construction Industry Report*, Issue 11, April 2000, but this might be expected if status reviews took place, as was intended, before the introduction of the new scheme.

be high and very careful consideration would have to be given to the costs and benefits of any such extension of the scheme.

4.26 Most significant for the purposes of this paper is the point that the CIS does not avoid the need to decide whether workers are employees or not. A different tax and NICs regime applies to employees from that applying to registered subcontractors, and subcontractors will not have employment rights. There is still, therefore, both a tax and NICs and an employment law incentive for contractors to use registered subcontractors even where the true relationship, on examination, could be said to be one of employment. This remains a contentious issue in the industry.

### *Agency workers*

4.27 Agency workers (broadly those whose labour is supplied to another on a temporary basis through an employment agency) are another non-standard group for whom status can be difficult to decide. From 1975, tax legislation has been in force to ensure that agency workers who work under the supervision, direction or control of a client are taxed under Schedule E rather than (as formerly) Schedule D. The agency workers in question are deemed to be employees of the agency for income tax purposes and the agency is responsible for operating PAYE.

4.28 Section 134 ICTA 1988 provides that the agency legislation applies for income tax purposes where a taxpayer provides his services to an 'employer' through a third party in such a way that technically he is not an employee of either.<sup>34</sup> The basic conditions for section 134 to apply can be summarised as follows. The person contracting with the agency must be an individual rendering personal services to the client and subject to supervision, direction or control of the client or other person as to the manner in which he renders those services. The individual must be supplied to the client by or through a third person (not necessarily an agency) and be under an obligation to render those services under the terms of a contract between himself and the agency. The legislation does not apply to contracts between third parties and companies, nor where workers are simply introduced to the client. The contract between worker and third party does not need to be written. The legislation can apply even where the worker sends a substitute to work for the client in his place.

4.29 The aim of the legislation was to ensure that, where an agency worker worked side by side with permanent employees, they were not taxed on a different basis. The policy reason behind the change was to maintain equity between similarly placed

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<sup>34</sup> If there is a contract of employment between the worker and the agency, then section 134 will not apply. In *Secretary of State for Employment v McMeechan* [1997] IRLR 353, the Court of Appeal decided exceptionally that the contract between the agency worker and the agency was a contract of employment. However, as the Revenue notes in its Schedule E Manual (713), 'we do not think that many agency contracts will turn out to be contracts of employment'.

taxpayers, to prevent the erosion of the Schedule E tax base and to provide certainty of status.<sup>35</sup>

4.30 A similar set of agency workers is classified for National Insurance purposes under the Social Security (Categorisation of Earners) Regulations 1978 (CATs Regulations) as ‘employed earners’.<sup>36</sup> These Regulations cover a person who is under an obligation to render personal service, subject to supervision, direction or control as to the manner of rendering such service, where that person is supplied by or through some third person and that third person retains an ongoing financial interest. The agency is the secondary contributor.

4.31 There is some inconsistency between the National Insurance and income tax definitions since the latter, but not the former, requires the existence of a contract of employment between the worker and the agency, whereas the CATs Regulations require an ongoing financial interest (unlike the tax requirements). Where the agency pays the worker, the two rules achieve the same end, but the results can differ where the client pays. Alignment of these rules was mooted in a review in 1994, but this has not occurred, and so the different rules can be an irritant which has no clear policy rationale.<sup>37</sup>

4.32 Some workers to whom section 134 and the CATs Regulations would otherwise apply are specifically exempted; these include certain homeworkers and fashion, photographic and artists’ models. In the past, there was an exemption from the income tax agency rules that did not apply for National Insurance purposes – for example, construction workers – but this anomaly has been removed.<sup>38</sup> Actors, singers, musicians and other entertainers are exempt from the tax charge, but not from NICs since July 1998, so a new difference exists.<sup>39</sup>

4.33 The expressed purposes of the special agency provisions are clearly achieved to some extent, particularly the prevention of the erosion of the tax base. One reason why taxpayers have been using personal service companies is to avoid the operation of the agency rules, but this will no longer be straightforward under the IR35 regime. The provisions do not, however, necessarily achieve equity as between similarly placed workers. The agency workers are taxed and pay NICs as if they were employees but, since for employment law purposes the test is the basic case law one (apart from recent legislative developments described below), they have few rights against the undertaking making use of their services. By contrast, the permanent employee has employment law protection.<sup>40</sup> The agency workers earn rights to

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<sup>35</sup> The Keith Report, fn. 19 Introduction above, vol. 1, ch. 5.

<sup>36</sup> SI 1978/1689, discussed further at paras 4.72 *et seq.* below.

<sup>37</sup> The DSS 1994 report, fn. 80 Chapter 3 above.

<sup>38</sup> See construction workers, paras 4.8 *et seq.* above.

<sup>39</sup> On actors and entertainers generally, see paras 4.57 *et seq.* below.

<sup>40</sup> The DTI employment status report, fn. 23 Introduction above; DTI Press Release, *Workplace is No Place for Second Class Treatment*, 15 July 1999.

contributory benefits, but only if they satisfy the contribution conditions, which they may not do if they are irregular earners. Thus they may be worse off than both their self-employed and their employee colleagues.

4.34 Further, the statutory definition of agency workers does not always result in certainty and consistency. There are various areas of doubt in connection with the income tax and CATs agency rules. For example, it is not clear whether they include workers such as professional lawyers and accountants, who may be self-employed partners in a genuine partnership but seconded to work in another company as a worker. The question of direction and control in relation to members of a profession can be particularly difficult.<sup>41</sup> Thus some definitional problems are avoided whilst others are created.

4.35 With increasingly flexible work patterns, agencies covering a wide range of occupations have proliferated and created more status cases with varied circumstances to determine. The DSS has commented that this has injected a degree of uncertainty back into agency situations and this is costly and contrary to the intention of the legislation. Agency workers are an expensive category of worker to determine because of the variety of working conditions and complex nature of the terms and engagement, requiring time-consuming inquiries.<sup>42</sup>

4.36 Agency workers also have an ambiguous status in terms of employment protection and it can be a complex matter to determine whether they are employees or not for these purposes. The mutuality obligation, which is so important for employment law because of the need to show continuity of employment for some forms of protection, gives agency workers particular problems.<sup>43</sup> Agency workers have now been given special status in recent employment law legislation, including the Working Time Directive and Minimum Wage Act 1998. Thus, for example, section 34 of the Minimum Wage Act provides that agency workers who are not otherwise 'workers' within the meaning of the Act, because of the absence of a worker's contract between the individual and the agent, or the principal, should nevertheless be covered by the minimum wage provisions.

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<sup>41</sup> See, for example, *Bhadra v Ellam* 60 TC 466 (on the facts, agency doctor working for NHS held to be covered by legislation as consultants had right to supervise his work, though actually there was little supervision). Contrast *Staples v Secretary of State for Social Services* (15 March 1985, unreported, cited in Tiley and Collison, fn. 7 Chapter 3 above, at para. 51.06); in this case, head chefs supplied on a temporary basis to a restaurant were held not to be subject to supervision and so did not fall within the legislation.

<sup>42</sup> The DSS 1994 report, fn. 80 Chapter 3 above.

<sup>43</sup> See, for example, *Wickens v Champion Employment Agency* [1984] ICR 365; the DTI employment status report, fn. 23 Introduction above, at para. 2.1.4. The Conduct of Employment Agencies and Employment Business Regulations 1976 do require the employment agency to provide a written statement indicating whether the worker is an employee or independent contractor.

4.37 Thus it can be seen that this technique, of deeming certain workers to be employees for some purposes, can serve a useful purpose. It also creates, however, new boundaries to be defined and policed and the potential for uncertainty and perhaps injustices if it is applied in one context without consideration being given to other contexts.

### *Homeworkers*

4.38 As Chapter 2 described, homeworkers may be divided into ‘traditional’ and ‘new technology’ homeworkers, the latter including teleworkers. Computers plus telecommunications now facilitate the performance of work at a distance from the employer. The more traditional homemaker occupations include machinists, punch operators, assemblers, packers and textile workers, where the capital-intensive work is performed in-house and much labour-intensive work is subcontracted out. Homeworkers may be self-employed or employed depending on the nature of the relationship between the parties. This variety of types of homeworking over a number of sectors would make any single approach for tax and NICs purposes very difficult. There is no single industry grouping or organisation to deal with, and the most appropriate rules to apply may vary considerably across this heterogeneous grouping.

4.39 It is not surprising, therefore, that there are no specific tax or NICs rules applying to homeworkers,<sup>44</sup> despite the increase in number of this group. This contrasts with employment law, where there are some specific provisions for homeworkers, as discussed below. The traditional homemaker, in particular, is often low-paid and isolated and lacks bargaining power. It makes sense for employment protection and related legislation to be extended to her. It is confusing, however, for a homemaker who has little advice available to her to learn that, though she is covered by some employment legislation, she is not an employee for other employment law purposes, or for tax and NICs purposes.<sup>45</sup>

4.40 From a tax and NICs point of view, there are two potential areas of difficulty for the homemaker. First, in some cases it may be difficult to determine the employment status of the worker because the facts point in different directions. The status may differ for tax and other purposes. Second, even where the facts are fairly straightforward and the worker is clearly an employee, there may be problems because the work is home-based – something not envisaged by the structure of the UK tax system. So it may be difficult to claim a proportion of household expenses, such as heating, lighting and telephone rental, because of the strict Schedule E expenses rules. In practice, research shows that even those homeworkers classified as self-employed

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<sup>44</sup> Except that, as explained above, homeworkers are expressly excluded from the special agency provisions.

<sup>45</sup> The National Group on Homeworking confirms that this is a practical problem (telephone conversation with author).

often do not claim those expenses against tax.<sup>46</sup> Thus, even when they are clearly employees for most purposes, homeworkers may need special treatment

4.41 In the UK, there is no special guidance literature available for homeworkers. The newly published Inland Revenue Employment Status Manual (ESM) deals with various groupings under separate headings, but usually only where an agreement has been reached with a trade body or similar. The National Group on Homeworking (NGH) has called for clear guidelines on status rulings.<sup>47</sup> Although the ESM does contain a wealth of detail, there is nothing expressly directed to homeworkers. A leaflet or other targeted guidance could be helpful, especially if it could be produced jointly with other government departments to explain the different rules that apply, the implications of different classifications and sources of advice and help.

4.42 Where there have been developments in the UK tax system directed at homeworkers, they have been aimed at the 'high-tech' homeworkers, who are generally employees of large firms choosing to organise themselves in this way. It is to be expected that this high-profile and articulate group would be more likely to gain concessions than the traditional homeworkers. For example, a limited tax relief has been introduced for computers lent to employees for home use, so that they are not taxed as benefits in kind, provided they do not exceed a certain value.<sup>48</sup> The Finance Act 2000 extends the exemption from charge as a benefit in kind for accommodation and supplies used by an employee *solely* in performing the duties of the employment, to situations where there is a private use by the employee that is not significant.<sup>49</sup> This deals with the practical problem facing employers in policing the *solely* test where employees use equipment at home.<sup>50</sup> In both these cases, the exemptions introduced are limited and hedged around with anti-avoidance provisions.

4.43 These limited provisions will assist firms with a policy of permitting homeworking, but they leave many questions uncovered and actually serve to highlight the rigidity of the general rules on expenses and benefits in kind for taxpayers who are employees working at home. So telephone line rental, where the telephone is used for personal purposes to a significant extent as well as business purposes, cannot be apportioned.<sup>51</sup> Apportionment of other costs may also be

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<sup>46</sup> See para. 2.32 above.

<sup>47</sup> Homeworkers' employment rights charter, reprinted in Stanworth 1996, fn. 59 Chapter 2 above.

<sup>48</sup> ICTA 1988 section 156 (A).

<sup>49</sup> Inserted as ICTA 1988 section 155ZA.

<sup>50</sup> The policy behind and operation of the new provision is described in Inland Revenue 49 *Tax Bulletin* October 2000, 779.

<sup>51</sup> The limited concession, which permitted some apportionment in certain circumstances (SE 4331), has been discontinued following introduction of the more precise rules in ICTA section 155ZA.

difficult.<sup>52</sup> The Inland Revenue's Schedule E Manual allows for deduction of costs where a room in the employee's house is set aside exclusively for business use, but not where the room has more than one use, since the expenditure cannot then be said to be exclusively for business use.<sup>53</sup> In those circumstances, only extra costs of heating and lighting may be claimed, but not a proportion of other expenses such as rates and rent.<sup>54</sup> Though the logic is consistent with that for deductibility of expenses under Schedule E generally, it has the practical consequence of penalising the less-well-off.

4.44 Working from home is an important model for future development and has many advantages in terms of saving travel and other costs. If it is to be facilitated, this piecemeal and rather rigid approach to providing the necessary tax reliefs may need to be reviewed. Certainly, it would be helpful for both 'high-tech' and 'traditional' homeworkers if the relevant rules were to be set out and explained in one place.<sup>55</sup> A thorough review of deductibility of expenses in relation to this group, who are required or expected by their employers to work at home, would be valuable. The problem for government would be that, once such a review took place for those working at home, there would be pressure for a wider review of the expenses rules. To create special rules for homeworkers could be to create new distortions *vis-à-vis* other groups. Certainly, though, special groups such as homeworkers should be taken into account in any general review of expenses rules and might provide an impetus for such a review.

4.45 Employee status is uncertain for homeworkers under employment law also. Employment tribunals have found homeworkers to be employees on some facts,<sup>56</sup> but it is clear from those cases that if the circumstances had been slightly different then the opposite conclusion could have been reached. Given the wide variations in the type of homework, the case law is of limited value as precedent.<sup>57</sup> Homeworkers are often excluded from employment protection because of a lack of mutuality of obligations. Even if the worker is able to show that he was employed under a contract of service, to claim most employment rights he has to be continuously employed for varying periods of time and this may be a problem for many homeworkers.<sup>58</sup>

4.46 These problems have led to pressure on government to broaden the scope of employment protection legislation to include workers, widely defined. The NGH records as an achievement the statutory definition of homeworkers in recent

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<sup>52</sup> See J. Freedman, 'The problem with apportionment', [1996] *British Tax Review* 634 (hereafter Freedman 1996).

<sup>53</sup> SE 32815, 32820, 32825.

<sup>54</sup> SE 32830.

<sup>55</sup> The section on household expenses in the Inland Revenue's Schedule E Manual is a start but is not easy to find for those not familiar with the manuals.

<sup>56</sup> *Airfix Footwear v Cope* [1978] ICR 1210; *Nethermere (St Neots) Ltd v Taverna and Gardiner* [1984] IRLR 240.

<sup>57</sup> K. Ewing, 'Homeworking: a framework for reform', (1982) 11 *Industrial Law Journal* 94.

<sup>58</sup> See Chapter 3 at paras 3.81–3.83 and generally, above.

legislation and lists amongst its aims the extension of all existing employment rights to homeworkers.

4.47 The National Minimum Wage Act 1998 is an example of legislation that expressly defines a homeworker, as well as covering workers rather than just employees.<sup>59</sup> The definition used is ‘an individual who contracts with a person, for the purposes of that person’s business, for the execution of work to be done in a place not under the control or management of that person’. The definition of worker in section 54 of that Act<sup>60</sup> is expressly extended in the case of homeworkers to include cases where services are not provided personally. Clearly, a homeworker may be covered by employment protection legislation but not be an employee for tax and NICs purposes.

4.48 The heterogeneous nature of homeworkers makes it difficult to provide guidance to them as a group. If guidance cannot be given to homeworkers as a single group, then industry-by-industry guidance might be appropriate. A project is being piloted in the fashion industry. Eight government departments, including the Inland Revenue, Customs and Excise, Employment Service and Benefits Agency, are working together to ‘deliver advice and help to the industry in a seamless way’.<sup>61</sup> The objective is to root out fraud and provide a level playing field for businesses that do meet tax, benefit and employment obligations. This co-ordinated approach could bring real advantages to homeworkers and others in the fashion industry, but will obviously be resource-intensive and hard to apply throughout the country. It might be helpful if it could be followed up with some easily accessible literature addressed to workers in this industry, especially homeworkers, whose services are widely used by the fashion industry, about their rights and employment status, including their tax and NICs position. This might then be a model for other sectors.

4.49 The NGH is pressing for the International Labour Organisation’s Convention on Homeworking to be ratified.<sup>62</sup> This would require government to promote equality of treatment between homeworkers and other wage-earners in such areas as maternity protection and social security protection. The UK has not ratified the Convention at the time of writing, but in the future we might well see further extensions of employment protection to homeworkers. If change were to occur in the employment law field, it would be helpful if there could be a review of the tax and NICs position to ensure that there are no unintentional discrepancies. It might well be found, on examination, that many members of the traditional group of homeworkers should properly be classified as employees for tax and NICs purposes without the need for any legislative intervention. Statutory clarification of this point, and possibly an extension of the definition for tax purposes to match that in the National Minimum Wage Act, could be very helpful to lower-paid homeworkers.

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<sup>59</sup> Section 35.

<sup>60</sup> See para. 4.110 below.

<sup>61</sup> Customs and Excise Press Release, *Innovative Project to Help the Fashion Industry*, 8 July 1999, [2000] STI 1202.

<sup>62</sup> Stanworth 1996, fn. 59 Chapter 2 above, at Appendix I.

4.50 Government wishes to encourage teleworking, but the only existing guidance on tax classification for such workers that it is able to point to is IR56.<sup>63</sup> A more detailed discussion related specifically to homeworkers of this type would be helpful. In addition, these new methods of working need to be borne in mind when tax reform is being considered.<sup>64</sup>

### *Casual workers*

4.51 There are three major classification problems experienced by casual workers. First, there is the question of defining employment status. Second, even if the worker is clearly an employee for the purposes of each separate employment, there are problems with this classification since the cumulative PAYE system is not designed for people moving into and out of employment. Third, the employment protection legislation, relying as it does on continuity of employment and mutuality of obligation, is not well adjusted to casual employees. In addition to these three points, casual workers are often seen as a problem in terms of tax evasion, since it is much easier for them to escape from paying tax of any kind than it is for those in more stable employment and those running an established business.

4.52 On the first point, the employment status of a casual worker may be unclear on the facts of a particular engagement because a worker who works for many different firms on a casual basis may have a very different relationship with them from one who works for only a few. As we have seen in Chapter 3, when discussing the decision in *Hall v Lorimer*,<sup>65</sup> it is not only the detailed provisions of a particular engagement that are relevant to employment status. The worker's personal circumstances, such as the number of other organisations to which he supplies services and whether he runs an office and takes a businesslike approach to arranging his engagements, are also relevant to status. This appears to be recognised by the Inland Revenue in its ESM. For example, whilst part-time lecturers will normally be treated as employees, factors personal to the particular lecturer, such as whether he carries on some related substantial profession or business activity, are to be taken into account in deciding his employment status.<sup>66</sup> Nevertheless, the business to which services are being provided will not necessarily know the worker's personal circumstances and may not wish to be involved in borderline classifications. The tendency for large organisations may be to treat certain types of worker as employees for tax and NICs purposes in relation to short-term contracts in order to protect themselves. Other less scrupulous businesses may be inclined to err in the opposite direction. Both can be difficult for the worker, depending on his circumstances, but he may have little power to influence his treatment by the client/employer.

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<sup>63</sup> See para. 2.37 above.

<sup>64</sup> Para. 2.20 above.

<sup>65</sup> [1994] STC 23.

<sup>66</sup> ESM 4502.

4.53 The second problem experienced by casual workers is that, even where they are clearly employees for tax and NICs purposes and are treated as such, they do not fit the cumulative PAYE system comfortably. They may have several employers in the relevant period and deducting the correct amount of tax can be complex and very costly in proportion to the actual payroll cost. The Keith Committee, which was also concerned with the evasion problem referred to above, noted this difficulty in 1983 and recommended a universal scheme for casual workers involving deduction at source at one-half basic rate, but this recommendation was not adopted.<sup>67</sup> The Bath survey on compliance costs<sup>68</sup> reported complaints from employers about the high costs of dealing with casuals. One response to this survey requested a system for casuals similar to the one used for subcontractors.

4.54 Special agreements have been reached with some trade bodies where there are many casual employees. For example, the Association of Market Survey Organisations operates a modified system of PAYE on payments made to market research interviewers.<sup>69</sup> This does not remove the individual's right to claim to be treated as self-employed, but, in effect, will encourage market survey organisations to treat workers as employees under this scheme for the sake of simplicity. This may point the way to a broader practical solution for casual employees for whom tax might be deducted at a flat rate. This is clearly easier to organise, however, where there is a reputable trade body with which to negotiate than across the board. If the scheme were to be universal, it would be necessary to define and somehow register the self-employed at one end and employees, who would not be part of the special scheme, at the other. Thus the problem of definition would not be avoided and a registration process would be needed. We have seen the difficulties encountered with the Construction Industry Scheme in this regard, in terms of compliance and administration costs, though it is arguable that a universal scheme would be fairer than the one we now have, which covers only one sector.

4.55 The third problem for casual workers is that of employment law protection. Each short-term casual engagement may well qualify as an employment for tax, NICs and employment law purposes, so that tax and NICs are deducted. If each contract is short-term, however, the worker may not get the full benefit of employment status for employment law or benefits purposes, even if he works for one employer on many successive occasions. The test will be one of mutuality of obligations, as we have seen in Chapter 3. The difficulty was illustrated in *O'Kelly v Trusthouse Forte*,<sup>70</sup> where regular casuals were paid weekly in arrears under deduction of tax and NICs but were held for employment law purposes by the Court of Appeal to be independent contractors. In *O'Kelly*, there was no contract of employment found to exist at all, though the decision was altogether somewhat unsatisfactory. It is now more usual for

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<sup>67</sup> The Keith Report, fn. 19 Introduction above, ch. 6.

<sup>68</sup> The Bath Report, fn. 8 Introduction above.

<sup>69</sup> ESM 4220.

<sup>70</sup> See fn. 45 Chapter 3 above.

a contract of employment to be found to exist in relation to the short-term engagement, as in *Carmichael v National Power*,<sup>71</sup> but not a longer-term ‘umbrella’ contract with that employer. Professor Hugh Collins argues convincingly that the employment law problem for casuals is not that they do not have a contract of employment, since they do, but that they lack the necessary continuity to establish qualifying periods. In his view, the answer is to use statutory techniques for extending continuity of employment rather than trying to construct ‘umbrella’ contracts. Thus, for example, short periods of employment can be combined under the Employment Rights Act 1996.<sup>72</sup>

4.56 Classification may be a problem for casual workers since they may have characteristics of the self-employed but also of part-time and temporary employees. They experience all the uncertainty discussed in Chapter 3 above. Even where they are properly classified as employees, they do not fit easily into rules designed for permanent employees. They may need special treatment to take them out of cumulative PAYE, as found in practice in some sectors. The application of such a scheme to all casuals would have many definitional and administrative problems. Conceptually, though a system of non-cumulative deduction at source might appear attractive, it may not give sufficient recognition to the fluidity of the work of casuals. An individual may be a part-time employee at one stage, but may work in an independent capacity at another, so that he is changing status frequently. A system of deduction at source might make it less important to get this classification right from the point of view of taxation, but it could remain important for other purposes. From the point of view of employment law, it seems that, although continuity of service is a problem for short-term casuals, there are existing special employment law rules which can be utilised to give some measure of employment protection.

### ***Entertainers/actors/film and TV industry workers***

#### Performers

4.57 The categorisation of entertainers for NICs and tax purposes has long been a source of difficulty. Entertainers are atypical workers, working for many different organisations, often at the same time. It is no coincidence that many of the leading cases on classification concern entertainers.<sup>73</sup> Nevertheless, only recently have any special categorisation provisions been introduced, and these only apply for NICs purposes.

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<sup>71</sup> See para. 3.85 above.

<sup>72</sup> Collins 2000, fn. 11 Chapter 1 above.

<sup>73</sup> The main cases being *Davies v Braithwaite* (fn. 28 Chapter 3) and *Fall v Hitchen* (fn. 30 Chapter 3).

4.58 Following the decision in *Fall v Hitchen* in 1973,<sup>74</sup> the Revenue took the view that all standard Equity contracts were contracts of employment. Performers were not treated consistently, however, and many were taxed under Schedule D. Consequently, meetings were held with representative bodies and, with effect from 6 April 1990, all standard Equity contracts were treated as falling under Schedule E and PAYE was applied. The employee was allowed a legislative deduction for certain agents' fees, which would not have been permitted under normal Schedule E rules.<sup>75</sup> Attempts during the 1991 Finance Bill debates to grant automatic or voluntary Schedule D status to actors came to nothing. On a purely concessionary basis, however, the Revenue agreed that any performer who could prove that he or she had been dealt with before 6 April 1987 under Schedule D could continue on that basis indefinitely (known as reserved Schedule D status). Any new entrant to the profession after that date would now automatically be dealt with under Schedule E.<sup>76</sup>

4.59 The DSS view continued to be that the Equity standard contract was clearly a contract of service, however long the engagement, because it gave very detailed control over the performer and it required personal service to be provided. The Revenue's past treatment of performers and its treatment of those with reserved Schedule D status were seen by the DSS as purely concessionary, aimed at simplifying the collection of tax. The DSS expected the producer to deduct and account for Class 1 NICs. Performers were content with this, since it entitled them to benefits in the event of unemployment, a not infrequent occurrence for most.

4.60 The Revenue view on the tax position was never accepted by the industry. It was based on the type of contract found in *Fall v Hitchen* in which the taxpayer would perform in various productions as and when required. This differed from the position of many actors, who were engaged for a specific part in a particular play. It also concentrated on the specific terms of the contract rather than the more general position of the performer in the context of his other engagements. In September 1993, the Special Commissioners ruled that live theatre work by actors Sam West and Alec McCowan should be taxed under Schedule D, not Schedule E.<sup>77</sup> The main issue for the actors seems to have been the deductibility of expenses. This decision was not appealed by the Revenue, which accepts now in its ESM that:

'It is clear from these contrasting cases that the terms of the contract may not be decisive by themselves and in the case of artistic workers ... the way in which they generally carry on their profession also needs to be considered.'<sup>78</sup>

4.61 Though this was now the tax position, most such workers continued to pay Class 1 NICs and claimed employee contributory benefits. There was great uncertainty

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<sup>74</sup> Discussed in Chapter 3 above.

<sup>75</sup> Section 201A ICTA 1988.

<sup>76</sup> Extra-statutory Concession A75.

<sup>77</sup> Unreported; see *The Tax Journal*, 12 August 1993.

<sup>78</sup> ESM 4121.

on the NICs position for over two years, although revised guidance on tax status for performers/artists was made public in Summer 1994. After some pressure on the government by Equity, in July 1998 the DSS issued a Press Release stating that special regulations would be tabled to require the majority of performers to be treated as employees for National Insurance purposes, despite being classified as self-employed for tax purposes.<sup>79</sup> Thus, from 17 July 1998, actors and musicians whose only or main remuneration consists of salary are categorised as employees for NICs purposes, although the income tax position will continue to be determined according to case law principles.<sup>80</sup>

4.62 The 1998 Press Release stated that

‘the Government are considering the longer term position of the entertainment industry in the light of the plans announced in the Chancellor’s Budget Statement concerning the alignment of tax and NI and will in due course make a further announcement’.

The 1998 amendment to the regulations was to cease to have effect on 1 February 1999, but that cessation date was subsequently removed by further regulations, with no new cessation date being set.<sup>81</sup>

4.63 Performers are, therefore, an example of a group of workers who may receive special treatment: self-employed status for the purposes of deduction of expenses, but employee status for the purpose of NICs and of claiming contributory benefits, due to their special circumstances. At least the non-alignment of tax and National Insurance is express and statutory. In effect, there is a deliberate policy decision to subsidise frequently unemployed performers by allowing them to claim non-means-tested jobseeker’s allowance. This is akin to a similar decision, also a response to industry pressure, to allow employed gas and oil divers to be treated as if they were carrying on a trade for income tax purposes.<sup>82</sup> Since the normal case law tests apply for NICs purposes, usually they will pay employee NICs.<sup>83</sup>

4.64 Unfortunately, the special provisions for actors are not a model for other groups. First, many uncertainties remain, since there is still a line to draw between

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<sup>79</sup> P. Vaines, ‘Taxing matters’, (1994) *New Law Journal*, 4 November; DSS Press Release 98/202, 15 July 1998. See CATs Regulations (above) as amended, Regulation 1(2), para. 5A in Part 1 of Schedule 1 and para. 10 in Schedule 3.

<sup>80</sup> Note that there are special provisions requiring a withholding tax to be paid in respect of certain payments to non-resident entertainers and sportsmen: ICTA 1988 sections 555–558.

<sup>81</sup> The Social Security (Categorisation of Earners) Amendment Regulations 1999, SI 1999/3.

<sup>82</sup> Section 314 ICTA 1988 deems that certain divers are assessable under Schedule D, despite the fact that they are employed.

<sup>83</sup> ESM 4050; Social Security (Contributions) Regulations 1979, Regulation 59 provides that divers covered by section 314 ICTA are excepted from liability to Class 4 NICs, presumably on the assumption that they will be paying employee NICs.

actors who are employed and self-employed both for NICs and tax purposes. The special provisions do not affect employment law. Perhaps even more problematic is the fact that the measure is still described as interim.<sup>84</sup> It would be helpful if government could face this special situation more openly and declare that special provisions had been made. The difficulty with the current situation is that a particular group with a well-organised, high-profile union has managed to obtain a ‘special deal’ for its members, but other groups that might have similar claims to some form of hybrid treatment (such as some homeworkers, possibly) are not being afforded the same opportunity.

#### Film and TV industry – behind-camera workers

4.65 This area is an example of one where there are very detailed agreements with relevant trade bodies about the classification of different types of worker. Even so, there are problems and uncertainties.

4.66 On 30 March 1983, the Inland Revenue announced that it had carried out a review of the employment status of workers engaged on free-lance terms within the film and allied industries. After extensive discussions, it had concluded that a number of workers engaged on free-lance terms were employees. By the end of 1983, over 7,000 workers had been recategorised as employed earners.<sup>85</sup>

4.67 The Revenue issued a note in 1994 on the application of the *Hall v Lorimer* case to the film and TV industry.<sup>86</sup> In 1992, the Contributions Agency published a note stating that it was now instructing its staff to use the Inland Revenue’s lists as a basis for identifying those most likely to be self-employed. The Inland Revenue announced revised arrangements in early 1995, however, under which production companies may pay without deduction of tax where any engagement of a person in the listed categories is for less than seven days (‘the seven-day rule’). Yet the guidance notes instruct the companies to apply Class 1 National Insurance to payments, even if no tax is deducted.

4.68 The Film Industry Unit of the Inland Revenue has now published a list of specified classes or ‘grades’ of casual and free-lance staff in the television and film industry who it regards as genuinely self-employed.<sup>87</sup> These include advance riggers, animal-handlers, editors, scenic artists, wardrobe workers and wig-makers. In order to qualify for self-employed status, a grade has to satisfy certain criteria, such as being

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<sup>84</sup> ESM 4145.

<sup>85</sup> *Hansard*, 16 January 1984, vol. 52, col. 14.

<sup>86</sup> Broadcasting, Entertainment, Cinematograph and Theatre Union (BECTU), *Tax Information for Freelance Members, Update*, August 1998.

<sup>87</sup> ESM 4101 *et seq.*

non-permanent or providing separate equipment.<sup>88</sup> All workers listed are automatically treated as self-employed, those not listed as employees. A worker has the right to object to the Film Industry Unit and ask for a review of status. These workers have used service companies to deal with the classification problem in the past, though the Inland Revenue has argued that this is ineffective.<sup>89</sup> Such companies will, in any event, now be subject to the IR35 legislation.

4.69 Effectively, this procedure gives the Inland Revenue a short cut to classification. Given the large number of individuals involved, the wide variety of activities undertaken by them in these fields and the different manners in which the activities are performed, such an approach can give rise to unfairness, but for those clearly treated as self-employed it provides the certainty of a useful 'safe harbour'.

4.70 Cases continue to be brought on status in this industry, notwithstanding the detailed level of guidance that has been agreed. Two National Insurance cases that decided that set-construction workers in the film and TV industries were self-employed have recently caused confusion because some Inland Revenue (National Insurance) Offices advised some companies that these decisions were of industry-wide application.<sup>90</sup> The Inland Revenue now argues that, since these were decisions on their own facts only, the previous position is unchanged and generally these workers are employees. Cases of doubt are to be referred to the Film Industry Unit and the agreed status will apply for both tax and NICs.<sup>91</sup>

4.71 These cases show how complex the application of the status rules can be, even within one industry. If a special unit is needed to give guidance despite the detailed listings agreed in this area, there is little hope that a more detailed definition of employment status would solve the problems of classification, but 'safe harbours' can give added certainty in some areas.

#### ***The Social Security (Categorisation of Earners) Regulations 1978 as amended (CATs Regulations)***

4.72 As noted above, in relation to agency workers, the CATs Regulations specify that certain earners are employed earners or self-employed workers for National Insurance purposes, irrespective of the general position under case law. The Secretary of State has the power to determine by statutory instrument that certain particular

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<sup>88</sup> For example, camera operators are accepted as self-employed if they normally provide substantial machinery; modellers are treated as self-employed if their engagement is either for less than nine months or on a one-off production such as a single documentary.

<sup>89</sup> ESM 4104.

<sup>90</sup> *Hamilton Heritage* and *Southbrooke Studios Ltd*, both 1997 and unreported, discussed in Inland Revenue 48 *Tax Bulletin* August 2000.

<sup>91</sup> *Tax Bulletin*, fn. 90 above.

groups of workers should be treated as employed or self-employed contributors and can extend or withdraw the categories.

4.73 For example, office cleaners are categorised as employees under the Regulations for National Insurance purposes, but the usual case law rules apply for tax and employment law purposes. Similarly, under the CATs Regulations: ministers of religion are generally treated as employees; part-time lecturers, teachers or instructors are treated as employees provided a number of conditions are satisfied; examiners of certain examining bodies are usually treated as self-employed; as noted earlier, agency workers and actors are treated as employees.

4.74 The rationale for these Regulations seems to be to deal with areas where it is perceived there has been avoidance of NICs in the past. They are also said to achieve equity where many workers are employees and it would be unfair for them to have to work side by side with workers not being treated as such.<sup>92</sup> Why the same reasoning does not apply to taxation as to National Insurance is less clear in all cases, although we have seen, with the example of actors discussed above, that there may be groups for which a hybrid classification could be argued to be appropriate on policy grounds. In the case of some of the other groups affected by the CATs Regulations, it may simply be that the NICs loss is considerably more significant than the tax loss involved. For some of these groups, there are also rules drawn up for tax purposes, either statutory, as in the case of agencies, or some form of non-statutory guidance, for example as is found in relation to part-time and short-term teachers and lecturers.<sup>93</sup> Unfortunately, even where there are rules for tax and NICs, they do not mirror each other, which adds unnecessary complexity.

4.75 In practice, the Regulations often seem to achieve a result similar to that that ought to be achieved by case law, properly applied. The purpose of the Regulations is in part to clarify and avoid disputes about particular categories of worker. This is clear from the fact that some workers, notably examiners, are to be treated as self-employed under the Regulations. The use of special statutory definitions for clarification in this way can be a useful device but can also be confusing if applied for one purpose but not another.

4.76 The DSS 1994 report referred to above considered whether these Regulations were obsolete, or could be simplified, or whether closer alignment with the income tax position could be achieved. It was acknowledged in the report that the Regulations were relatively costly to administer, which does raise real questions about their purpose. Nevertheless, few changes were proposed. In many instances, differences between the Regulations and the tax position were thought not to be causing practical problems. This does not, however, seem to be a good reason for retaining unnecessary differences.

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<sup>92</sup> This is the reasoning given in the DSS 1994 report, fn. 80 Chapter 3 above, ch. 8.

<sup>93</sup> Committee of Vice-Chancellors and Principals, *Tax Guidance: Lecturers Engaged by Universities (as Agreed with Inland Revenue)*, 1 April 1996.

4.77 As a general policy matter, given the government's desire to align tax and National Insurance and following the merger of the Contributions Agency and the Inland Revenue, it may now be an appropriate time to review the CATs Regulations again and consider whether an express alignment with tax law would be helpful.

### ***Personal service companies and other intermediaries (IR35)***

4.78 This section considers the issue of personal service companies in the context of this paper only. It does not attempt a detailed analysis of the new rules, which have been the subject of many articles and other writings.<sup>94</sup> This paper also does not address the wider question of the incentives created by the tax system to use different legal structures as a medium for carrying out business.<sup>95</sup> The only aim here is to analyse the use of personal service intermediaries as just one of the classification difficulties created by the current structure of the UK tax and NICs system.

#### The issues addressed

4.79 Many workers falling within the 'problem' categories described above, or other 'grey areas', have in the past used an intermediary through which to supply their services. The intermediary has usually been a company owned and controlled by the worker.<sup>96</sup> In some industries, incorporation has been encouraged or even insisted upon by agencies or large firms, in order to avoid the organisation to which services are provided being subject to employment legislation and employee tax and NICs treatment for the worker.<sup>97</sup> Use of a personal service company effectively avoids the ICTA section 134 agency rules.<sup>98</sup>

4.80 In other instances, the choice to incorporate has been that of the worker. He may have various reasons for this. There are tax and NICs incentives for such a choice. Prior to the introduction of the new legislation, if all remuneration was paid to

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<sup>94</sup> See, particularly, Redston, fn. 47 Chapter 3 above.

<sup>95</sup> That is, the issue of the choice of business medium as between incorporation and unincorporated status. From April 2001, there is to be the further choice of a Limited Liability Partnership (LLP) that will couple taxation as a partnership with a measure of limited liability. At present, the LLP is not user-friendly for very small firms, and anti-avoidance tax legislation is to be introduced in the 2001 Budget which may further limit its attractiveness – Inland Revenue Pre-Budget Report Press Release, 5, 8 November 2000.

<sup>96</sup> Other arrangements are possible, such as partnerships, but are less common and less advantageous. Highly artificial composite companies were also formed and marketed as a tax avoidance scheme, which was one of the developments that led to legislation (see Redston, fn. 47 Chapter 3 above, at p. 6).

<sup>97</sup> J. Freedman and M. Godwin, 'Legal form, tax and the micro-business', (1992) in K. Caley, E. Chell, F. Chittenden and C. Mason (eds), *Small Enterprise Development*, Paul Chapman Publishing Ltd, London (hereafter, Freedman and Godwin).

<sup>98</sup> Inland Revenue Decision RD 4, February 1992.

a personal service company owned by the worker as a gross fee, he could arrange for the personal service company to pay much of this to him (and his relations) as dividends. Such payments were not subject to NICs and could be spread around family members to ensure that the higher rates of tax were not reached, or not reached as quickly as would otherwise be the case. A minimum salary could be paid to safeguard contributory benefits. Some of the earnings could be retained in the company at the lower corporate tax rates for companies with small profits.<sup>99</sup> Deductions for expenses could be made for corporation tax purposes that would not be permitted against a straightforward salary paid direct to the worker. Other tax planning also might be possible. Savings would be made by both the worker and the client and no doubt shared between them by virtue of adjustments in the price paid for the job.

4.81 In the past, generally this has been effective for tax purposes. The Inland Revenue has had little success in arguing that it should be able to look through the veil of a properly incorporated company in normal circumstances.<sup>100</sup> It will be noted that the tax and NICs incentives of using a company are embedded in the structure of the system. The differences between taxation of dividends and remuneration, the fact that NICs are a charge on earnings only, the low corporate tax rate and the rigidity of the rules on deductibility of expenses by employees all play a part. The low corporate tax rate, in particular, has been introduced specifically to encourage small businesses in corporate form and it is not surprising that taxpayers and their advisers should seek to utilise this. In addition, incorporation is encouraged by the absence of a minimum capital requirement, or other barriers commonly found in other European jurisdictions, and, now, the removal of the statutory audit requirement for many small companies.<sup>101</sup> Again, this is government policy and it may be thought reasonable for those providing services to take advantage of this policy just as those supplying goods or engaging in other activities may do.<sup>102</sup>

4.82 Some workers had mainly tax and NICs reasons for setting up service companies and this was particularly true of those using highly artificial composite companies and other marketed schemes.<sup>103</sup> These workers might properly be compared with employees and it might be thought only reasonable that they should be taxed in the same way as employees, on grounds of equity. Others, however, also had

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<sup>99</sup> There are reliefs for companies with profits below certain thresholds, which will often benefit personal service companies so that they have to pay only 10 or 20 per cent on their profits (ICTA 1988 sections 13 and 13 AA).

<sup>100</sup> RD 4, fn. 98 above, though see the Inland Revenue's comments on service companies in the entertainment industry, para. 4.68 above.

<sup>101</sup> Prior to this change, many who incorporated purely for tax purposes found the costs of incorporation unsatisfactory – Freedman and Godwin, fn. 97 above.

<sup>102</sup> For a fuller discussion of the policy of encouraging incorporation, see J. Freedman, 'Limited liability: large company theory and small firms', (2000) 63 *Modern Law Review* 317.

<sup>103</sup> See fn. 96 above.

commercial reasons for incorporation, such as obtaining limited liability or even prestige.<sup>104</sup> An entrepreneurial worker might set up a company through which to provide his services for these commercial reasons, even though initially he is providing services to one client only, like B in the example in Chapter 1 above. His aim may be to develop this business and it may be unclear at inception whether this will be possible. This latter type of worker should be compared with other businesses working through companies and taxed on the same basis, otherwise he will be at a competitive disadvantage and may even be prevented from developing his business. Taxing him as an employee risks keeping him as an employee by making it difficult for him to take on staff, invest in equipment and pay for training at the early stages of his enterprise.<sup>105</sup>

4.83 The Inland Revenue intended to target personal service companies that were 'disguised employees' with its new legislation for personal service companies, originally heralded in the notorious IR35 Press Release<sup>106</sup> and now contained in the Finance Act 2000.<sup>107</sup> Its intention was to remove opportunities for avoidance of tax and Class 1 NICs and to ensure that businesses employing direct labour were not put at a disadvantage. In part the aim was to provide a structure in which workers would be more likely to return to a direct employment contract with organisations where that was the appropriate expression of the relationship.<sup>108</sup>

4.84 The problem the Inland Revenue has faced is the difficulty of differentiating between the two types of business described above: the genuine small business and the 'disguised employee'.<sup>109</sup> Much of the debate surrounding this legislation has been, in effect, about the problem of separating out the users of personal service companies who are truly akin to employees, from those who should more properly be compared with the self-employed and who are running a business on their own account. Much of the anger generated by the provisions resulted from the concern of those who have legally utilised incentives in the tax and business organisations system, and who consider themselves to be contributing to the economy by setting up businesses, that they were being described as 'tax avoiders'. Some of this concern is exaggerated. Some of the people expressing concern will satisfy the criteria for running their own business and will not be caught by the new legislation. Nevertheless, there is sufficient uncertainty about the application of the legislation for some on the borderline to feel aggrieved.

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<sup>104</sup> Freedman and Godwin, fn. 97 above.

<sup>105</sup> Because tax deductions are not permitted or because, though they will eventually be permitted, there is a cash-flow problem due to deduction at source until the existence of a business is established.

<sup>106</sup> Inland Revenue Press Release, 35, March 1999, [1999] STI 469.

<sup>107</sup> Section 60 of and Schedule 12 to the Finance Act 2000. See also The Social Security Contributions (Intermediaries) Regulations 2000 (SI 2000/727).

<sup>108</sup> The Welfare Reform and Pensions Bill 1999, Regulatory Impact Assessment, Appendix 6.

<sup>109</sup> See Chapter 2 above.

4.85 Despite the mass of literature and debate on this legislation, the fundamental problem is the one discussed in this paper: classification. The new legislation does nothing to solve this problem, merely relying on the old case law to draw the line. The new provisions operate where an individual worker provides personal services to a client via an intermediary and he would, under general tax and National Insurance law,<sup>110</sup> have been classified as an employee of the client, were it not for the interposition of the intermediary. This simply poses the old question in a different context: where there is an intermediary. By closing what the Inland Revenue sees as a loophole, it also removes one method that in the past has created a measure of certainty within an uncertain tax scenario for those commencing in business.

4.86 Critics of the new legislation have claimed that it does not recognise the risks many entrepreneurs take when establishing their own business.<sup>111</sup> The Professional Contractors Group (PCG), set up expressly to challenge the legislation, has obtained permission from the High Court to proceed to a full hearing of its case for judicial review of the new personal service companies legislation.<sup>112</sup> The government will contest this. One of the PCG's grounds is that the legislation amounts to illegal state aid as it taxes small contractors more harshly than their larger competitors.<sup>113</sup> The crucial question here centres on our fundamental issue. Which comparator is to be used – employees or the self-employed?

4.87 Government would deny that the legislation will catch those who are actually running a business, and it is clearly not intended to, but the test is too uncertain in application to be sure. What is more, the case law approach may not take into account sufficiently the dynamic nature of business creation: someone who is a 'disguised employee' at one point can develop into an entrepreneur, given the right conditions. The worry is that the personal service companies legislation, as applied by the Inland Revenue, will not be sophisticated enough to recognise this. Since it relies upon the case law, it may be that it will take some time for test cases brought by organisations such as the PCG to be decided and to throw light upon how well the tests will adapt to the personal service companies situation. The advantage of case law is that it can be flexible and, as seen in the case of *Hall v Lorimer*, for example, it can develop with changing economic conditions. The disadvantage is that there may be lack of clarity for some years whilst case law emerges. Whether the case law ultimately results in an

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<sup>110</sup> This includes the CATs Regulations, so it is possible for a person operating through a personal service intermediary to be caught by the new rules for NICs, but not income tax purposes – see Redston, fn. 47 Chapter 3 above, at p. 209.

<sup>111</sup> Association of Chartered Certified Accountants, *High Court ruling threatening IR35 tax plan welcomed*, 11 October 2000, [2000] STI 1483.

<sup>112</sup> [2000] STI 1481 *et seq.*

<sup>113</sup> *The Professional Contractors Group and Judicial Review Relating to IR35*, [www.pcggroup.org.uk/jr-background](http://www.pcggroup.org.uk/jr-background). Other grounds are that there is a breach of the EU right of establishment and the legislation is disproportionate to its stated aims and a *de facto* confiscation of property contrary to the Human Rights Act 1998.

adequate and sufficiently certain framework will depend upon the level of guidance the courts are prepared to give, as discussed in Chapter 3 above.

### Australia

4.88 The UK government is by no means unique in deciding that personal service companies need to be disregarded for some tax purposes, but other techniques have been used in some other countries. A complete survey of other jurisdictions is outside the scope of this paper, but it is worth noting that Australia, as part of its review of business taxation, has this year introduced the New Business Tax System (Alienation of Personal Services Income) Act 2000.<sup>114</sup> Under this Act, personal services income earned by an interposed entity is included in the assessable income of the individual who performed the services, but not if he is carrying on a 'personal services business'.

4.89 'Personal services business' is the concept that draws the line between carrying on a business and supplying only personal services, and this is defined by legislation. Under this legislation, there are three tests for a personal services business: the employment test, the business premises test and the unrelated clients test. The employment test relates to whether the worker engages others to do at least 20 per cent of the principal work he is paid to provide. The business premises test relates to whether the worker uses and maintains physically separate business premises to conduct the activities that gain or produce the income. The unrelated clients test relates to whether the worker has two or more clients to whom he provides services as a direct result of offering his services to the general public or a section of the public, for example as a result of advertising.

4.90 If less than 80 per cent of the worker's personal services income is received from one client (including associates of that client) and one of the above tests is satisfied, there will be a personal services business. Even if more than 80 per cent of the personal services income is from one client, it may be possible to obtain a 'personal services business determination' that a personal services business exists.

4.91 Thus the Australians have used a different technique from the UK in attacking the personal service companies problem. The case law is not relied upon as in the UK. The Australian tests may seem more objective and certain than the UK tests. On the other hand, the Australian tests are complex and there are already several guidance notes on the Australian Tax Office's website to guide taxpayers through them. A number of definitions are still needed and there might be scope for manipulation that would then have to be countered by further legislation. The operation of the new

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<sup>114</sup> *Ralph Review of Business Taxation*, July 1999, [www.rbt.treasury.gov.au/publications](http://www.rbt.treasury.gov.au/publications), ch. 7; *Tax News Service*, 9 October 2000, p. 381; notes on alienation of personal services income, [www.ato.gov.au](http://www.ato.gov.au).

Australian legislation, which was modelled on existing state payroll tax arrangements, will be interesting to monitor alongside the UK provisions.<sup>115</sup>

### IR35 and employment law

4.92 The UK legislation on personal service companies does not deem workers caught by it to be employees of the organisation to which services are being supplied, but merely subjects them to tax and NICs as if they were so employed. The legislation has no direct impact on employment legislation. As we have seen, though, employment tribunals are more willing to look through the corporate veil than are the courts in tax cases.<sup>116</sup> The new tax and NICs treatment might encourage further decisions that workers engaged through personal service companies are employees for the purpose of employment protection, but there is no statutory alignment of the position and the case law outcome is uncertain.

4.93 One of the problems with the IR35 legislation is that it leaves the possibility that workers will be taxed and pay NICs as if they were employees of the client of the intermediary, but they will have none of the employment law advantages of actually being employed by that client. Under the proposals made by the Inland Revenue originally,<sup>117</sup> the client would have had to deduct tax and National Insurance if the worker was caught by the new rules. This might have produced some incentive to take the workers on as employees to avoid uncertainty, or at least would have been a disincentive to laying off employees to be replaced by free-lance workers operating through personal service companies. Representations by potential client companies and their advisers meant that the proposal was altered to place the obligation on the worker. This certainly reduced costs for larger businesses and was a popular change judging by responses, but it does shift the compliance cost onto individual workers, who may be even less well equipped to deal with it than the clients.

4.94 Further, it means that the incentive in the original proposal for client firms to return to direct employment contracts has now largely been removed, although provision of such an incentive was one of the aims of the reform expressed by the government. Indeed, in some ways, the new rules are an incentive for businesses to

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<sup>115</sup> By contrast, the Canadian legislation on personal service businesses incorporates the case law test of employee status. Income from personal services is eligible for fewer deductions than other business income and subject to the top corporate rate of tax. J. Magee, 'Whose business is it? Employees versus independent contractors', (1997) 45 *Canadian Tax Journal* 584.

<sup>116</sup> See, for example, *Catamaran Cruisers Case Ltd v Williams*, discussed in Chapter 3 above.

<sup>117</sup> Inland Revenue paper, April 1999. This paper was sent only to those bodies that had responded to the Budget Press Release. One criticism of the process is that this was not properly published and indeed states at its head that it is not a consultation document. News of the paper spread, however and the Inland Revenue finally received 1,700 responses (Redston, fn. 47 Chapter 3 above, at p. 9).

insist on always contracting through personal service companies rather than direct with the individual. This is because the client business of a personal service company runs no risk of penalties or arrears in the event that the arrangement is reclassified. By contrast, if a self-employed worker is reclassified, the client could face penalties. Thus the client business can reduce its own compliance burden by paying the company gross and letting the worker sort matters out.

4.95 So individual workers might find they are required by client firms to continue to operate through personal service companies and they will pay the tax and NICs costs of employment without the employment law benefits. In some instances, of course, they may be classified as employees by tribunals, especially if the legislation in question refers to workers rather than employees, but the outcome is not certain. These workers could theoretically be the subject of an extension of employment protection in the legislation, but the government has not indicated an intention to take any such action.<sup>118</sup>

#### Effect of the legislation

4.96 Under the original proposals, the worker would be caught if he was working under the control of the client and the personal service company was not on a public register of certified businesses. These proposals did not use the case law tests for determining employment status, but a rather simple and quite inadequate and outdated test of supervision, direction or control. This would have been very confusing and would have caught some personal service company workers who would have been classified as self-employed without the existence of the intermediary.

4.97 Following the pressure from business described above, the Inland Revenue altered its proposals in September 1999, and the new provisions were enacted in the Finance Act 2000 and came into force on 6 April 2000. The main classification issue for decision is now whether the worker would be regarded as an employee if his services were provided direct to the client, rather than through an intermediary.

4.98 If an engagement is caught by the new rules, the gross income received by the intermediary in respect of the engagement is treated as a Schedule E payment made by the intermediary to the worker. To the extent that it has not already been paid out as salary, it will be deemed to have been paid on 5 April; tax and National Insurance (both the employer's and employee's contribution, of course) will be due on 6 July following. A deduction is allowed for employer's NICs, expenses allowable under Schedule E including employee capital allowances, employer pension contributions, VAT and a further 5 per cent of the gross amount received after VAT to cover

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<sup>118</sup> Statements in the parliamentary debates indicate that the intention is not to change employment law; see, for example, the debates in Standing Committee H, Tuesday 6 June 2000 (pt 7).

administrative costs.<sup>119</sup> Apart from the cost to the worker in terms of NICs, this can have an important impact in terms of the expenses that are deductible. In particular, there are complaints that training costs cannot be deducted, since the rules on deduction of these for employees are very rigid. This, it is suggested, will hinder development of businesses, especially in the IT sector where constant training is necessary.<sup>120</sup> The government has stated that this treatment of training costs is to put those operating through personal service companies in the same position as employees,<sup>121</sup> but of course employees are more likely to have their training funded by their employer. This means that personal service company workers may suffer a real extra burden.

4.99 Estimates vary as to the costs and the impact of the new legislation. The PCG argues that many skilled workers are leaving the country because of the legislation, but so far the evidence is anecdotal. Perhaps more systematic evidence of this and the compliance costs on business will be produced at the judicial review hearing due to be held in February 2001. Even the Inland Revenue, however, has estimated that the costs for contractors in 'learning the rules, consulting with advisers over the effects and possibly altering the terms of their contracts' will be around £15–20 million for 1999–2000.<sup>122</sup>

4.100 The new legislation and the response to it has led to a major review by the Inland Revenue of its guidance on employment status and a new ESM has been published on the Inland Revenue website. This will be helpful for all borderline workers, not just personal service company workers. Chapter 3 above contains comments on some of the points made in the ESM. The new guidance is very detailed, but the large number of factors listed for consideration mainly serve to highlight how complex the area has become. Despite the accessibility of the advice, it is not clear that it would be easy for a worker to make a clear assessment of his position for himself. There is also a new Inland Revenue leaflet<sup>123</sup> and a *Tax Bulletin* article with detailed examples,<sup>124</sup> both on the website. Even then, a really borderline worker could be left in doubt, since the guidance can only be as clear as the case law, which we

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<sup>119</sup> It is clearly envisaged by government that the VAT position will be unchanged by the new legislation (IR35 Frequently Asked Questions). This attitude of the VAT courts remains to be seen. Though workers caught by the personal service intermediaries legislation are not employees for the purposes of income tax law, even though they are taxed as such, the VAT tribunal might be prepared to look at the purpose of the VAT directives (see para. 3.107 above).

<sup>120</sup> A point that has been made by the PCG on its website, fn. 151 Chapter 3 above, and which was also made forcibly at a Meeting of the Committee of London Society of Chartered Accountants and the Tax Faculty of the ICAEW (2 October 2000).

<sup>121</sup> D. Primarolo, 2 December 1999, Inland Revenue website, IR35 page.

<sup>122</sup> The Welfare Reform and Pensions Bill 1999, Revised Regulatory Impact Assessment, at para. 27.

<sup>123</sup> IR175.

<sup>124</sup> Inland Revenue 45 *Tax Bulletin* February 2000.

have seen is very dependent on the facts and does not cover every combination and eventuality.

#### Alternative approaches

4.101 The discussion above raises the question of whether it would not have been preferable to have consulted more extensively on the personal service company provisions in order to produce a narrower definition of those to be covered by the legislation. New or refined tests for when the legislation should apply, such as those used in Australia, could have been devised. Such tests might have risked missing some element of avoidance, but they could have been designed to catch cases of clear abuse and to provide 'safe harbours', leaving those attempting to set up new businesses free from the doubt that will now beset some of them. It is true that the original proposal did put forward a special test, but this was so obviously inadequate that it did not test the possibilities satisfactorily.

4.102 Another approach might have been to tackle the problem at corporate level, requiring a proportion of income to be distributed as salary rather than dividends.<sup>125</sup> This would have had the result of dealing with this method of avoiding NICs for all company owners, not only those providing personal services. A further option would have been a tax on undistributed income of close companies from some sources, as under the personal holding company provisions in the US.<sup>126</sup> None of these approaches would have been without difficulty, but they would have been worth discussion. Instead, such alternative options as were considered by the government had been discounted by the time the decision to legislate on this area was announced and so

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<sup>125</sup> This approach is adopted in Belgium, where at least one director of a company claiming the decreased corporate tax rate for small and medium-sized enterprises must receive a minimum remuneration of a certain amount which is subject to social security contributions and individual income tax. See C. Vanderkerken, 'Belgian national report', (2000) in B. Wiman (ed.), *Taxation of Small and Medium Sized Enterprises*, MercurIUS Stockholm School of Economics, Stockholm, at p. 68.

<sup>126</sup> Section 541 Internal Revenue Code. This also covers some income other than that from the provision of personal services. Various other methods are also available to the US Internal Revenue Service to attack personal service companies, including sections 482 and 269, which permit reallocation of income in some circumstances and denial of reliefs and allowances. See also section 269A of the Code, which applies to personal service corporations serving a single customer and permits reallocation of income to the controlling shareholder/employee in some circumstances. For a discussion of these provisions, see R. Westin, J. K. McNulty and R. Beck, *Federal Income Taxation of Business Enterprises: Cases, Statutes, Rulings*, (1999) Lexis Publishing, New York, at ch. 13 and p. 545.

there was no opportunity for public debate and sharing of experiences of other jurisdictions.<sup>127</sup>

### Inland Revenue guidance

4.103 The Inland Revenue guidance provided is reasonably helpful and balanced, with some exceptions as discussed in Chapter 3 above. Though it has been criticised, it has also been commented that its authors sometimes bend over backwards to be fair to the taxpayer.<sup>128</sup> Consultation has resulted in improvements to the guidance, so that *Hall v Lorimer* is now taken into account and it is admitted that personal factors, which have little to do with the terms of the particular engagement being considered, may be relevant. Even so, it might be difficult for workers who commonly operate by taking a series of short-term but full-time contracts to show that they have, or will have, several clients in their first year or so of operation. The snapshot nature of the rules may create difficulties here.

4.104 Litigation on some borderline test cases is inevitable, given the new interest and importance of the status tests. Workers will be pressing for decisions that they are not akin to employees. They seem likely to depend particularly on some factors that have been important in recent employment law cases to deny workers employment status, such as mutuality and ability to substitute another worker. As we have seen, the former of these in particular has not been important for tax purposes in the past, but this could change.<sup>129</sup> Any such litigation could have an impact on the development of the status rules generally, exerting greater pressure than before for findings of self-employment. Workers who would prefer a broader definition of employment could be adversely affected by a series of decisions made in the context of personal service companies. Even though these will be confined to their own facts, there will be a tendency for them to be relied upon in court by those seeking to argue against employment in other contexts.

4.105 In an attempt to improve certainty, the Inland Revenue has now offered to provide opinions on status for IR35 purposes on receipt of email, post or fax details of contracts and surrounding circumstances.<sup>130</sup> It will aim to reply to requests for advice within 28 days of receiving all the details. This is helpful and relatively speedy for a public body. It would be impractical, no doubt, for any tighter time-limit to be specified. Nevertheless, this seems unlikely to satisfy totally those workers who habitually operate on the borderline. The Inland Revenue will not comment on hypothetical contracts, but by the time the contract has been negotiated sufficiently to

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<sup>127</sup> The Welfare and Pensions Bill 1999, Regulatory Impact Assessment. The alternatives discussed there are put up merely to be knocked down and would have been impractical: for example, the outlawing of the use of intermediaries in the provision of personal services.

<sup>128</sup> Redston, fn. 47 Chapter 3 above, at p. 106.

<sup>129</sup> Redston, fn. 47 Chapter 3 above, at p. 108.

<sup>130</sup> Inland Revenue Press Release, 7 February 2000, [2000] STI 149.

be non-hypothetical there may be some urgency. Workers may not be able to wait for 28 days for a determination, but if they agree the contract, particularly the price, before they know the tax position, they may have difficulties. Clearly, if IR35 catches the engagement, the fee will need to be higher to produce the same income. The setting-out of the system for written opinions as has been done is, nevertheless, undoubtedly helpful. This culture of willingness to give rulings and the more detailed advice available may be of assistance to those seeking status rulings generally.<sup>131</sup>

#### Personal service intermediaries: conclusion

4.106 In summary, the personal service intermediaries legislation has solved none of the classification problems but has highlighted the operational difficulties of the current case law. The increased importance of the case law may place on it a very great strain, although it may also be that the courts will eventually show the flexibility necessary to develop the law to suit the new circumstances. More extensive consultation would have been desirable in order to avoid spreading the net too wide in an area where distinctions are difficult. The new legislation, in its haste to prevent tax avoidance, some of which undoubtedly existed, shows little understanding of the fragility of nascent small businesses and of their need to grow from modest beginnings. It has also failed to provide an incentive to client companies to take on more direct employees, again because of the rushed nature of its introduction and lack of comprehensive consultation with different groupings.

#### **Extending employment legislation: the concept of worker**

4.107 The reaction in the field of employment law to problems about whether borderline workers are employees for employment protection purposes has been to include legislative extensions in the more recent Acts to ensure that a wider range of workers are protected. The DTI employment status report and accompanying Press Release<sup>132</sup> suggest that further extensions of this type will be considered. We have seen the value of this in our discussion of homeworkers.

4.108 The Equal Pay Act 1970, Sex Discrimination Act 1975<sup>133</sup> and Health and Safety at Work Act 1974 extend the ordinary meaning of an employee to cover those employed under 'a contract personally to execute any work or labour'. Clearly, this will cover some self-employed workers. In *Quinnen v Hovells*,<sup>134</sup> for example, a self-employed salesman demonstrating goods in a department store was held to be covered by the Sex Discrimination Act 1975.

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<sup>131</sup> As to which, see Chapter 5 below and ESM 0129.

<sup>132</sup> Fn. 23 Introduction above and fn. 40 above.

<sup>133</sup> Section 82(1). See also section 78(1) of the Race Relations Act 1976 and section 4 of the Disability Discrimination Act 1995.

<sup>134</sup> [1984] ICR 525.

4.109 In recent employment legislation, the term ‘worker’ has also been used in preference to the term ‘employee’. Statutes that refer to workers for at least some purposes include the Employment Rights Act 1996, the National Minimum Wage Act 1998, the Employment Rights (Dispute Resolution) Act 1998, the Working Time Regulations 1998 and the Part Time Workers (Prevention of Less Favourable Treatment) Regulations 2000.

4.110 For example, in the National Minimum Wage Act, worker is defined to mean

‘an individual who has entered into or works under (or where the employment has ceased, worked under) a contract of employment or any other contract, whether express or implied and (if it is express) whether oral or in writing, whereby the individual undertakes to do or perform personally any work or services for another party to the contract whose status is not by virtue of the contract that of a client or customer of any profession or business undertaking carried on by the individual.’<sup>135</sup>

4.111 The burden of proof is normally on the worker to show that he is an employee, but this has been reversed in the National Minimum Wage Act to place the burden on the employer to demonstrate that the individual is not within the definition of a worker. Thus an individual is presumed to qualify for the national minimum wage unless the contrary is established.<sup>136</sup>

4.112 Section 230(3) of the Employment Rights Act 1996 defines workers in a similar way to the National Minimum Wage Act, although most provisions of the Employment Rights Act refer only to employees. The other provisions mentioned also use a similar definition.

4.113 Section 23 of the Employment Relations Act 1999 confers upon the Secretary of State power by order to extend statutory employment rights to individuals who do not presently enjoy them. The government has explained that it envisages using this power to ensure that all workers, other than the genuinely self-employed, enjoy the minimum standards of protection that the legislation is intended to provide and that none are excluded simply because of technicalities relating to the type of contract or other arrangement under which they are engaged.<sup>137</sup>

4.114 Despite this extension, it can be seen that the statutory definition of worker is not free from uncertainty. It is thought that it moves away from the mutuality obligation, which is so problematic in employment law. It includes certain independent contractors who perform work personally, but it excludes, for example, a person carrying on a business undertaking. This seems to throw us back onto some of the old cases on the existence of such a business and may mean that this definition of

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<sup>135</sup> Section 54.

<sup>136</sup> Section 28.

<sup>137</sup> DTI, *Fairness at Work*, (1998) Cm. 3968, at para. 3.18 and Press Release, July 1999, fn. 40 above.

worker is not, in the end, all that far away from the tax definition of employee. It has been stated that ‘the courts do not have a coherent vision, let alone definition, of what constitutes a business’.<sup>138</sup> This may make the line between a worker and an independent entrepreneur just as unclear as the line between the employed and self-employed.<sup>139</sup> The DTI employment status report suggests that adopting the definition of worker will, at best, increase the number covered by employment rights by 5 per cent.

4.115 As seen in Chapter 3, the requirement to do work personally is also quite restrictive and means that, for example, sub-postmasters are excluded from protection.<sup>140</sup> It has also been held that a pupil barrister is not a worker for the purposes of the National Minimum Wage Act.<sup>141</sup>

4.116 To eliminate any uncertainty that might otherwise arise from the definition of a worker, the protection of the National Minimum Wage Act has been extended to two further classes of person whether or not they are ‘workers’ within the meaning of the Act: agency workers and homeworkers.<sup>142</sup> In determining for the purposes of this Act whether a homeworker is a worker, section 54, cited above, has effect as if the word ‘personally’ were substituted by ‘(whether personally or otherwise)’. Homeworker is defined by section 35 of the Act to mean

‘an individual who contracts with a person, for the purposes of that person’s business, for the execution of work to be done in a place not under the control or management of that person.’

This extension has not been applied in other recent legislation, such as the Part Time Workers Regulations 2000, however, despite pressure from the TUC.<sup>143</sup> There is power to add to the protected classes by regulation ‘any individual of a prescribed description who would not otherwise be a worker’.

4.117 There may be policy reasons that justify the use of different definitions in different circumstances, but these justifications are not always clear and the differences can be obscure and confusing. It would be helpful if coherent guidance could be published for workers about the relationship between their rights in different areas. The exercise of constructing such a document could highlight the areas where unnecessary differences existed and could be eliminated. Differences required due to the different objectives of the legislation could then be made clear and transparent. Where workers are paying tax and NICs as employees, there will be a sense of injustice if they are not also treated as employees for employment protection purposes.

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<sup>138</sup> D. Brodie, cited in the DTI employment status report, fn. 23 Introduction above, at p. 17.

<sup>139</sup> The DTI employment status report, fn. 23 Introduction above, at p. 18

<sup>140</sup> *Sheehan v Post Office Counters Ltd* [1999] ICR 734 (EAT).

<sup>141</sup> *Edmonds v Lawson* [2000] 2 WLR 1091 (CA).

<sup>142</sup> Sections 34 and 35.

<sup>143</sup> *Financial Times*, 18 January 2000.

The extension of protection to workers could assist in eliminating some of these cases, though, since the definition of worker comprises that of employee and raises issues of its own, classification remains a problem to be dealt with, even where the term 'worker' is used in legislation.

## CHAPTER 5: LEGAL DECISION-MAKING MECHANISMS

**This chapter examines the decision-making mechanisms used in relation to classifying a worker's status at an administrative level, as well as the system of appeals to tribunals and courts. The position has improved since the merger of the Contributions Agency and the Inland Revenue in April 1999 and the transfer of NICs appeals to the Tax Commissioners. Nevertheless, it is still the case that several different bodies may be concerned with determining the status of workers.**

### Background

5.1 Employment law appeals often arise after the termination of a relationship and relate to claims for unfair dismissal, discrimination and similar. Delay can be confusing, create anxiety and cause financial difficulty, but the relationship is frequently at an end in any event, so ongoing arrangements are not affected.<sup>1</sup>

5.2 In the case of tax and National Insurance, the position is frequently rather different, since the taxpayer will often need to establish his status prospectively in order to make his arrangements and cost his services *vis-à-vis* the engager for the future. There can be a high cost to a person found to be an employer if he has not been operating PAYE in relation to the relevant employee, so some engagers will insist on deducting PAYE and National Insurance until a formal ruling has been obtained.<sup>2</sup> For this reason, administrative methods of determination are very important in this area.

5.3 Using a personal service intermediary may be thought to avoid this problem, even under the new legislation, since payments are made to the intermediary gross. The rules do not affect the engager. For this reason, personal service intermediaries may still be insisted upon by the client/engager to give certainty as to tax treatment for himself. This does not, however, help the worker. He needs to know in advance how the profits from an engagement will be treated for tax and NICs purposes, since this will affect the fee he is to charge.

5.4 The importance of an early determination of the position for tax and NICs purposes means that most taxpayers will need to establish their position with the Inland Revenue, rather than taking a case to formal appeal. This increases the importance of administrative methods of determination. It is likely, however, that we

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<sup>1</sup> This is not always true – for example, see the *Carmichael* case, fn. 32 Chapter 3 above. The nature of the relationship may be an issue that a trade union, for example, takes up whilst the relationships between worker and engager continue to exist.

<sup>2</sup> For the responsibility of an employer to deduct and pay over income tax under PAYE, see Income Tax (Employments) Regulations 1993 SI 1993/744 as amended and the Appendix to this paper.

shall see some test cases on status going to appeal in relation to personal service intermediaries.<sup>3</sup> These may give the courts an opportunity to provide further guidance in the case law, as suggested above. Whether there will be an opportunity for the courts to comment on the employment law situation with personal service companies remains to be seen.<sup>4</sup>

## **The different tribunals**

5.5 Prior to the Social Security (Transfer of Functions etc) Act 1999, National Insurance status questions in England and Wales went to the Office for Determination of Contribution Questions, then to the Secretary of State and finally to the High Court, beyond which there was no right of appeal. The appeals system for status disputes in relation to National Insurance was merged with that for tax in April 1999.<sup>5</sup> This system remains separate from employment law, VAT tribunal and general legal decisions on status. The effect of the variety of judicial processes for answering the same or very similar questions on the development of the jurisprudence has been discussed in Chapter 3 above.

5.6 Tax and National Insurance appeals in England and Wales go first to the General or Special Commissioners and then on to the High Court, Court of Appeal and House of Lords.<sup>6</sup> The General Commissioners are laypeople; the Special Commissioners are legally qualified. The latter's decisions are usually a matter of public record. VAT cases on status are heard by the VAT and Duties Tribunal (where there is a significant overlap of personnel with the Special Commissioners). Again, decisions are published. Employment law questions are determined first by an employment tribunal, which is chaired by a lawyer with two interested laypeople.<sup>7</sup> Decisions are published. There is then an appeal to an employment appeal tribunal chaired by a judge with two laypeople, followed by appeal to the Court of Appeal.

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<sup>3</sup> This has been indicated by the PCG on its website, fn. 151 Chapter 3 above.

<sup>4</sup> The government envisages that VAT will be paid by personal service intermediaries and that the new legislation will not affect this (IR35 Frequently Asked Questions). Many personal service intermediaries will be below the VAT threshold in any event, but, for those that are not, a challenge to this view might be possible. This could rely directly on the VAT directives.

<sup>5</sup> As recommended by the TLRC in its Report on *National Insurance Contributions Disputes*, Institute for Fiscal Studies, London, 1998.

<sup>6</sup> In Scotland, appeals go from the Commissioners to the Court of Session. The TLRC's discussion of and recommendations for reform of the tax appeals system can be found in TLRC, *Interim Report on the Tax Appeals System*, (1996) Institute for Fiscal Studies, London and TLRC, *A Unified Tax Tribunals System*, (1999) Institute for Fiscal Studies, London.

<sup>7</sup> Formerly industrial tribunals. Sometimes cases are heard by one legally qualified person alone, and there have been some complaints that this is happening increasingly.

5.7 The Social Security Contributions (Transfer of Functions etc) Act 1999 provides for many National Insurance appeals to be subject to a decision by an officer of the Board of Inland Revenue.<sup>8</sup> This procedure applies, *inter alia*, to

- whether a person is or was an earner and, if so, the category;
- whether a person is or was liable to pay contributions of particular class and, if so, the amount;
- whether contributions of a particular class have been paid in respect of a period;
- issues in connection with entitlement and other matters related to statutory sick pay and statutory maternity pay.

5.8 An appeal from a decision of the Board must be made in writing within 30 days after the issue of the decision.<sup>9</sup> The appeal will then be heard by the Tax Commissioners and thereafter as any tax appeal.

5.9 The Social Security Contributions (Transfer of Functions etc) Act 1999 could not expressly provide for decisions taken by the Commissioners on National Insurance matters to be binding for tax purposes and vice versa, since the Act covers only National Insurance matters. This could be problematic, even though it is the Inland Revenue's intention to treat decisions on one area as relevant to the other. Status Inspectors are advised in the ESM to arrange for appeals on tax and NICs status by the same worker to be heard by the Commissioners at a joint hearing. They are told that 'failure to do this could result in different bodies of Commissioners coming to a different decision on status'.<sup>10</sup> It is worrying that this must be avoided by relying on officials making appropriate arrangements on an *ad hoc* basis, as it can be imagined that some cases may slip through the net. It seems that conflicting status decisions would still be possible on NICs and tax and it might be desirable to introduce some legislative measure to prevent this.

### **The administrative approach – Status Officers**

5.10 The merger of the Contributions Agency and the Inland Revenue<sup>11</sup> has transferred the day-to-day operational functions of the Contributions Agency from the DSS to the Revenue, which now has a duty to collect NICs.<sup>12</sup> All income tax and NICs

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<sup>8</sup> Section 8.

<sup>9</sup> Section 11 of the Social Security Contributions (Transfer of Functions etc) Act 1999.

<sup>10</sup> ESM 0121.

<sup>11</sup> This came into effect in April 1999 under Part 1 of the Social Security Contributions (Transfer of Functions etc) Act 1999.

<sup>12</sup> This gives statutory effect to the Common Approach which was first agreed between the Revenue and Contributions Agency in April 1987 in response to criticisms from business.

status questions are initially decided locally, with support from Status Officers and Technical Support Managers based in network offices.<sup>13</sup> Most Status Inspectors will be part of the Employer Compliance Unit structure. They are required to handle the case in a consistent manner with regard to both NICs and tax aspects.<sup>14</sup>

5.11 The Inland Revenue has a public commitment to provide guidance and, if requested, a written opinion on employment status.<sup>15</sup> The Inland Revenue treats any such written opinion as binding, except where it can be shown that misleading information was provided or that the facts have changed. Where an earlier opinion is decided to have been technically incorrect, the Inland Revenue normally expects to be bound by it for the past, but will seek to alter it for the future.<sup>16</sup> These written opinions are not formal decisions and carry no right to appeal.<sup>17</sup>

5.12 The ESM makes it clear that opinions by officials of the Board of Inland Revenue on tax and NICs status should be the same unless there is an express difference between them as a result of the CATs Regulations<sup>18</sup> or other special provisions (see Chapter 4 above). There could also be a lack of uniformity because the question being asked in each case is actually a different one (for example, the question for NICs purposes may be whether the person is an earner at all, rather than whether he is employed or self-employed).<sup>19</sup> Whilst this point is not unreasonable in itself, the statement in the ESM that opinions about NICs in such cases need not mention income tax treatment is less than helpful, since the taxpayer could be left very confused.

5.13 The statement of the Inland Revenue's commitment to give rulings, now clearly set out in the new ESM, is helpful. There are two main problems. First, there is no deadline for the giving of a status opinion. Second, the Inland Revenue will not give a firm opinion about status before a worker has commenced work.<sup>20</sup> It is clear why the latter point is made, since otherwise a taxpayer or engager could keep submitting contracts with adjustments until obtaining the desired opinion. On the other hand, it will be difficult to agree pricing and other details without knowing in advance how the Inland Revenue will treat the contract.

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The intention was to have closer operational alignment by providing for specific procedures to be followed by both departments when considering enquiries about employment status.

<sup>13</sup> ESM 0102.

<sup>14</sup> ESM 0104.

<sup>15</sup> ESM 1001.

<sup>16</sup> ESM 0112.

<sup>17</sup> ESM 0107.

<sup>18</sup> ESM 0002.

<sup>19</sup> ESM 0126 – although in such a case there would be a similar question to be decided for income tax purposes relating to the source of income and whether it was income or capital.

<sup>20</sup> ESM 0129.

5.14 In relation to the new personal service intermediaries legislation, the Inland Revenue has said that it will aim to reply to any requests for advice within 28 days of receiving all the details. A written contract, or written details of an oral contract, must be submitted and the Revenue will still not comment on hypothetical contracts, which personal service intermediary owners argue is unhelpful, but there is evidence of an Inland Revenue aim to give as much advance guidance as possible.<sup>21</sup> It has commented on a version of a model contract, though emphasising that the opinion given on this contract was in relation to one person's particular circumstances.<sup>22</sup>

5.15 The 28-day guideline applies in general to Inland Revenue correspondence and so to all requests for written opinions, whether or not related to the new legislation, but there is no guarantee that the 28-day time-frame will be adhered to, especially in marginal cases with complex facts. The 28-day time-limit can easily be overridden by the Status Officer seeking more information. A mandatory time-limit would probably be impractical, since further information often will be required and these decisions are not straightforward. On the other hand, delay can cause real hardship for the worker and additional compliance costs for all parties. It would be desirable for some time-frame to be referred to, at least for guidance, in the ESM, as it is for IR35 cases. At the moment, the ESM does not appear to refer to any time-limits at all. The fact that the Revenue has felt able to provide a time-frame in relation to personal service companies suggests that similar clearance procedures subject to time-limits may be possible in other areas. It would seem unreasonable for status enquiries to be dealt with more quickly for those with personal service intermediaries than for those less-sophisticated taxpayers who are supplying services directly.

5.16 In the past, there has been no statistical data available about the number of applications for status opinions or the time taken to respond to them. There was anecdotal evidence of delay causing hardship<sup>23</sup> and a measure of evidence from the Adjudicator of some hard cases.<sup>24</sup>

5.17 It seems that some data are now being compiled about status enquiries, at least in relation to the personal service intermediaries legislation. It was reported in

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<sup>21</sup> Inland Revenue Press Release, [2000] STI 149.

<sup>22</sup> IR35 Frequently Asked Questions.

<sup>23</sup> This comment is made as a result of anecdotal evidence from Equity, TaxAid and others. See also frequent queries on status in the pages of *Taxation* – for example: July 1999, p. 435 on workers being reclassified in a haulage business; the detailed article in 25 November 1999, p. 184 on reclassifying part-time workers in the security industry: 'There were substantial delays in correspondence. During the four year period at least five different Inspectors of Taxes dealt with the case.'; 11 March 1999, query on subcontractor reclassification; 28 January 1999, query on subcontractor status; 27 March 1997 at pp. 757 and 758, where a worker in the film industry was given a different status from his colleagues in the same occupation putting him at a competitive disadvantage.

<sup>24</sup> For example, Case CA9, 1998 Inland Revenue Adjudicator's Annual Report and Case A7 Inland Revenue Adjudicator's Annual Report 1995.

*Hansard* in June 2000 that over 1,200 contracts had been submitted to the Inland Revenue under the new IR35 procedure. Fifty-three per cent had been found to be within the new legislation, but 47 per cent were outside it.<sup>25</sup> This has been taken to indicate an even-handed approach,<sup>26</sup> although it may just be that taxpayers who are clearly self-employed have been made unduly nervous by the publicity over the new legislation, so that contracts were being submitted where there was obviously no question of being caught by the legislation. If statistics can be compiled in relation to the new legislation, then it is hoped they will also be kept in relation to written opinions on status given in cases of direct supply of services.

5.18 Publication of these statistics as well as examples of recent opinions given by the Inland Revenue might be of some assistance in ensuring that the case law is applied consistently by the Revenue across all districts and as a way of monitoring decisions. It has already been suggested that more examples should be included in booklets produced for the taxpayers. It would need to be made clear that this was purely guidance and could not set any precedents.

5.19 Where the worker does not accept the informal, non-appealable written opinion of the Inland Revenue under the above procedure, the next step is to move to a formal procedure.<sup>27</sup> The Inland Revenue will make a formal decision under section 8 of the Social Security Contributions (Transfer of Functions etc) Act 1999 in relation to NICs. A formal appealable status decision on income taxation involves the issue of a determination under Regulation 49 of the Income Tax (Employments) Regulations 1993<sup>28</sup> on the engager.<sup>29</sup> As mentioned above, administrative arrangements are in place to require that all disputes involving NICs and income tax status are referred to a nominated Status Officer in the Tax Office before a formal decision or determination is made, to ensure a co-ordinated approach to status disputes.<sup>30</sup>

## **Chapter conclusions**

5.20 It can be seen that, despite the merger of the Inland Revenue and the Contributions Agency, complete merger of status opinions has been difficult. There are some areas where the law is different, or slightly different questions are being addressed. An opinion of a court in one area does not officially bind in respect of the other. There is an awareness of these problems and it is hoped that they will be dealt with administratively, though this needs to be monitored.

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<sup>25</sup> HC 6 June 2000, cited in Redston, fn. 47 Chapter 3 above, p. 120.

<sup>26</sup> Redston, fn. 47 Chapter 3 above.

<sup>27</sup> The procedure is set out in the Inland Revenue 41 *Tax Bulletin* June 1999.

<sup>28</sup> SI 1993/744.

<sup>29</sup> ESM 0121.

<sup>30</sup> *Tax Bulletin* 41, fn. 27 above.

5.21 Given these problems within a merged organisation, a single status appeals body across all areas, including employment law, does not seem to be a practical option. The variety of contexts in which the issue of status arises and the statutory variations and additional tests to be applied in some cases would mean that even one tribunal might come to different decisions on similar facts. Delay would be created if cases had to be adjourned to a status tribunal before there could be a full hearing of the issues. Guidance from the higher courts, as suggested in Chapter 3, seems a more realistic option, but an objective of total consistency between different areas of law is illusory.

5.22 The merger of the Inland Revenue and the Contributions Agency has brought some important improvements and the Common Approach should now be easier to achieve. This is dependent, however, upon administrative guidelines since theoretically conflicting decisions could be reached by different bodies of Tax Commissioners on tax and NICs. This seems unfortunate.

5.23 There is evidence in the new ESM and from the way in which personal service intermediary inquiries have been handled that the Inland Revenue is attempting to give prompt and balanced advice. It is difficult to lay down formal deadlines for what is an informal administrative procedure, but a practice statement about time-limits for responses would assist taxpayers in this area where time can be very important. It would be regrettable if resources were put into dealing with high-profile personal service intermediaries' requests for opinions, but standard inquiries from those supplying services direct and their engagers were not dealt with so promptly.

5.24 Publication of statistics and examples of written opinions could do much to instil confidence, provide guidance and facilitate monitoring of the Inland Revenue's system of dealing with status issues.

## **CHAPTER 6: SUMMARY OF ANALYSIS, ISSUES FOR FURTHER CONSIDERATION, QUESTIONS AND WIDER ISSUES FOR RESEARCH**

### **Summary of analysis**

6.1 A number of questions arise from this paper and some suggestions can be made for further research and discussion. As made clear above, these questions and suggestions do not represent TLRC proposals, but are intended to stimulate debate. Comments are welcome on the paper and particularly on the points raised below. Any comments should be sent to Judith Freedman, c/o The TLRC, IFS, 3<sup>rd</sup> Floor, 7 Ridgmount Street, London, WC1E 7AE.

6.2 The central issue examined in this paper is worker classification. As discussed in the Introduction, reforms in this area alone cannot remove the difficulties created by tax and NICs differences in treatment between the employed and the self-employed. This would require more radical change, which is considered briefly under 'Wider issues for future research' below. Some improvements could be made, however, by increasing certainty of worker classification and making special statutory provision for particular groups of workers.

6.3 Chapter 1 describes the spectrum of workers and shows that, whilst at each end of the spectrum there are clear differences between the employed and self-employed, so that different tax and NICs treatment may be appropriate, there are also workers in the 'grey area' at the borderline of the classification divide. The proper taxation and NICs treatment of these workers may be less clear. There are also workers falling obviously on one side of the classification divide or the other for whom the tax and NICs treatment applicable to that classification seems inappropriate, due to some special characteristic of that group of workers.

6.4 Chapter 2 examines the evidence on changing work patterns and considers the implications of this for the rules on tax classification. There are more non-standard workers than previously. The majority of businesses in the UK are sole traders or partnerships without employees, a number of whom will be 'grey area' workers. Government wishes to encourage entrepreneurship, but the evidence on work patterns and businesses in existence shows how difficult it is for governments to target tax reliefs and incentives to benefit certain types of business it considers to be 'entrepreneurial' to the exclusion of others. There are statutory attempts being introduced to distinguish 'genuine businesses' from 'false self-employment' in many jurisdictions, but this is a very difficult line to draw. Businesses may start small, with only one client, and develop, or they may remain service only providers, which are more properly described as 'disguised wage-labourers'. It may be hard to draw a line between them at the outset, but discriminating between them for tax and NICs purposes may inhibit commercial development. Chapters 2 and 3 refer briefly to attempts in some other jurisdictions to deal with this problem.

6.5 The fast-growing group of homeworkers is examined. Traditional homeworkers must be distinguished from teleworkers and others using new technology to work at home. Both groups may need special consideration in relation to tax and NICs policy (as they have had under employment law). Development of policies for the new technology homeworker need to take taxation issues into account: some special allowances and rules may be required to adapt taxation rules to this new way of working.

6.6 Chapter 2 shows how the increase in all types of non-standard work puts pressure on the case law system of classification of workers by increasing the number of workers on the border. Even where classification is not an issue, the rules developed for standard workers may be less appropriate for the increasing number of non-standard workers. Examples are cumulative PAYE and the expenses rules.

6.7 Chapter 3 considers the UK case law on employment status and compares the approach of the courts in income tax, National Insurance, VAT and employment law cases. This examination suggests that a new statutory definition of employment or self-employment would be little improvement on the case law test. Most countries have multi-factorial tests, as does the UK. A simple, objective test would be too rigid and arbitrary and open to manipulation. The case law has in the past shown the flexibility to meet changing conditions. The courts also have the scope to lay down a legal framework, which could give a level of certainty in this area. On occasion, they have been prepared to do this in the past, but a greater willingness to express points as mixed questions of law and fact, rather than claiming that the issues before them are ones of pure fact, could be helpful. This could become even more important in the context of the pressure on the case law that results from the new personal service intermediaries legislation.

6.8 Certainty could also be improved by the use of statutory devices, as has occurred in some other jurisdictions and, to some extent, the UK. Some statutory approaches are discussed in Chapter 4. These include treating workers as if they were employees for some or all purposes (for example, agency workers, actors, persons supplying services through personal service intermediaries), applying a special procedure to certain workers, such as deduction at source within the construction industry, and bypassing the concept of employee altogether by extending provisions to 'workers'. Chapter 4 discusses the advantages and disadvantages of special statutory treatment for these and some other groups. It also shows that problems of classification are not necessarily avoided by statutory provisions. New definitional issues, or old ones in a new form, may arise. It is difficult to escape the need for the concepts of employee and of running one's own business or enterprise.

6.9 Chapters 3 and 5 discuss the problem of differences in the treatment of worker status in different areas of law. Alignment in all areas might not be possible or even desirable, especially if different policy objectives are being pursued. Where the case law to be applied is supposedly identical, however, it is confusing and unfortunate if the jurisprudence in different areas of law develops in different ways. Chapter 5 examines decision-making mechanisms for the classification of workers for tax,

National Insurance and employment law purposes. It welcomes the fact that status decisions for tax and National Insurance are now heard by the same tribunal. It would seem impractical to extend this to all types of status decision, but courts need to be clear about the principles they are applying and the reasons for applying those principles. Statutory divergencies also need to be based on different policy objectives, rather than arising from chance or the failure of different government departments to provide a co-ordinated approach. Chapter 5 also considers administrative guidance and decision-making on tax and NICs classification issues.

## **Issues for further consideration and questions**

### *Increased judicial guidance and willingness to lay down points of law*

6.10 Rigid judicial or statutory weightings of factors would not be possible, nor desirable, due to the variety of fact situations and working patterns. In recent years, however, there have been some indications that courts are prepared to make statements and findings, which have been valuable in providing subsequent guidance. The treatment by the courts of employment status as a mixed question of law and fact, and not pure fact, is important for the development of consistency in this area. The courts have the scope to create guidelines appropriate for modern conditions and there are some welcome indications that they are willing to do this. This development would not necessitate the undermining of fact-finding tribunals nor the encouragement of large numbers of appeals from those tribunals, which would be administratively unwieldy. It is, rather, a call not to be over-ready to treat questions as pure questions of fact, but to be prepared to intervene in order to provide consistency in application of the factors relevant to worker status.

**[See Chapter 3 generally and especially paragraphs 3.2–3.6, 3.102–3.105 and 3.119]**

**Comments are invited on whether development of more points of law in this area is seen as possible and helpful.**

### *Use of statutory extensions to cover particular groups*

6.11 The tax system could extend and tailor its definitions of employees and the self-employed, as has been done in employment protection legislation that extends provisions to ‘workers’. In the area of taxation, agency workers are already treated as if they were employees. Actors are treated as employees for NICs purposes but self-employed for tax purposes. This is a technique that could be considered in relation to other non-standard workers.

6.12 It would be very difficult to provide in detail for all possible varieties of non-standard workers through extended definitions, and such a multi-classification approach has to be balanced with administrative feasibility. The more classifications there are, the more boundary lines there are. This could increase uncertainty. On the

other hand, multi-classifications may be necessary if the tax system is to deal fairly with the complexities that exist as a matter of economic reality.

6.13 Statutory definitions can be tailored to meet the special requirements of particular groups, remove doubt and shift the burden of proof. For example, many homeworkers who wish to be treated as employed for NICs purposes, in order to be entitled to benefits, and for employment law protection purposes have difficulty in persuading their clients/employers to treat them as such. Often they would be employees on a proper application of the case law but are not treated as such due to practice in the industry. They may have little bargaining power or understanding of how to challenge their treatment. A definition like that in the National Minimum Wage Act 1998, making it clear that homeworkers satisfying certain conditions were intended to be treated as employees by tax and NICs legislation, would be helpful to them. This technique has been used for some categories in the CATs Regulations for NICs purposes, but it could be further used and extended to cover taxation. An alternative would be to treat homeworkers as employees for NICs purposes and self-employed for tax purposes, as in the case of actors, since they may have some expenses which would be deductible under Schedule D and not Schedule E.

**[See paragraphs 4.27 *et seq.* (agency workers), 4.38 *et seq.* (homeworkers), 4.57 *et seq.* (entertainers and actors) and 4.72–4.75 (CATs Regulations)]**

**Comments are invited on whether further statutory extensions of the definition of employment in particular cases would be helpful and, if so, in what areas it might assist and for which purposes.**

***‘Safe harbours’ to carve out certain groups***

6.14 A related device to increase certainty is a ‘safe harbour’. An extra-statutory example of this can be seen in the case of specified grades of staff in the film and television industry who are listed by the Inland Revenue as self-employed. This increases certainty for those covered, provided it is binding on the Inland Revenue. It does not alter the law, being only an application of the law as the Inland Revenue perceives it, but it can provide helpful guidance. It will be much easier to give industry-specific ‘safe harbours’ of this kind than general ones, given the varieties of work practices and facts that may exist.

**[See paragraphs 4.68–4.71]**

6.15 In practice, those using personal service companies had attempted to create their own ‘safe harbour’: a device that would make it unlikely that they would be argued to be employees of their clients. This has now been prevented by the new personal service intermediaries legislation. Arguably, this ‘taxpayer-made safe harbour’ was too wide, but some modified version could be considered. The concerns felt over the burden being placed on the case law test of employment status by the new

legislation could be eased by the addition of some legislative or extra-statutory ‘safe harbours’.

**[See paragraphs 4.78 *et seq.*]**

6.16 The Australian personal services income legislation defines personal services business, which is exempt from the operation of the legislation. The definition seems complex and possibly susceptible to manipulation, but its operation should be monitored, alongside the operation of the UK personal services legislation, so that comparisons can be made.

**[See paragraphs 4.88 *et seq.*]**

6.17 Simple ‘safe harbours’ risk being manipulated, whilst more complex ones add to compliance and administrative costs and may not increase certainty since they bring their own definitional difficulties. At the same time, they may provide valuable guidance and assurance to taxpayers. A layered approach could be devised. This could be based on the existing case law test to give flexibility but be overlaid with some more objective guidance measures. For example, it could be provided that a worker would not be caught by the personal service intermediary legislation if he received less than a certain percentage of relevant income from any one client. The percentage could be set low, because anyone not satisfying this test would still be able to argue that he was not caught by the legislation due to the operation of the normal case law test. This would not alter the law, therefore, but it would clearly and definitely take out some obvious cases who would not need to consider the application of the case law test.

6.18 It might be argued that this would add complexity for no real gain, since the persons protected would be self-employed under the case law tests in any event. The level of uncertainty and anxiety generated by the introduction of the new legislation may settle down after a year or so of operation. To introduce new tests would only unsettle matters again. These are valid objections which might suggest that the operation of the legislation should be monitored. If the Inland Revenue is receiving large numbers of queries on particular sets of facts, it could be found helpful to create ‘safe harbours’ to carve out some of these cases, leaving the general guidance procedure to deal with only more equivocal cases. The ‘safe harbours’ could be created by legislation or, possibly, Inland Revenue practice statements. If ‘safe harbours’ are introduced, arguably they should apply to workers engaged directly by firms as well as to those operating through intermediaries, to provide a level playing field.

6.19 In the past, the Institute of Directors has suggested that workers should be given a choice as to their employment status for tax and NICs purposes.<sup>1</sup> This would be unacceptable on grounds of revenue loss and lack of equity, for the reasons

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<sup>1</sup> Discussed and rejected in the DSS 1994 report, fn. 80 Chapter 3 above.

explained in this paper. Not only would those opting for self-employment generally pay less tax and NICs than if they were employees, but they might have a greater opportunity to evade tax, since it would not be deducted at source. It is also inconceivable that an election would be acceptable in relation to employment law. For public policy reasons, contracting out could not be permitted. In its latest report on this area, the Institute of Directors does not propose this election.<sup>2</sup>

**Comments are invited on whether safe harbours could be helpful to increase certainty in relation to the personal service intermediaries legislation or any other area. If so, should they be statutory, as in Australia, or would extra-statutory statements be adequate?**

### *Relationship between tax, National Insurance law and employment protection legislation*

6.20 Tax law and employment law have very different objectives. Tax law concerns the relationship of the taxpayer with the state and seeks to ensure that he pays a fair share of taxation, in a way that is administratively practical and efficient. Employment law is generally about providing the worker with appropriate protection and safeguards and his relationship with his employer/client. There may be good reasons for different definitions of employee to be adopted in these different situations. This can, however, cause compliance costs and confusion. For example, a worker may be defined for tax purposes as Schedule E and have to pay Class 1 NICs, but be held not to be an employee for certain employment law purposes (perhaps because of the mutuality factor). If he is dismissed, he may be able to claim jobseeker's allowance (based on his Class 1 contributions and subject to his contribution record) but be unable to claim unfair dismissal, because he is not an employee for this purpose, or at least not one with sufficient continuous service.

**[See paragraphs 3.81 *et seq.* and A28–A31]**

6.21 Variations in definition of who is to be covered by different pieces of legislation may be statutory. They may also arise, however, as described in Chapter 3, because the courts sometimes purport to be applying case law tests derived from the same authorities but, in practice, emphasise different factors. Employment tribunals in particular may take a purposive approach to interpretation of legislation. It is not possible to be certain that an employment tribunal will reach the same conclusion on status as a tax tribunal, even if the test is apparently the same one in each case. On appeal, the higher courts may be reluctant to overturn a decision based largely on an interpretation of the facts.

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<sup>2</sup> IOD paper 1998, fn. 17 Introduction above. This paper does propose what it calls a separate entity approach, which has some similarities to an election, as a way of escaping alignment problems, but the idea is not worked through and is stated without much conviction.

6.22 Two alternative developments could be helpful here. The House of Lords could spell out that status decisions based on the same general case law without statutory adaptation should not depend upon the circumstances. This would help to reduce emergent divergencies in the jurisprudence. Alternatively, it could make an express statement that different policy considerations may affect the outcome of a case and clearly delink the development of tax and employment law. The former approach would have the advantage that policy differences would be left to the legislature to spell out, but the latter might be thought necessary to ensure that full effect is given to legislation intended to be protective and to remove irrelevant considerations from both areas. Whichever route is taken, it needs to be transparent and clear to users. What is difficult to accept is the position we have now, where there is lip-service paid to common principles but the application of them differs.

6.23 These divergences in application in different areas of law are masked by the emphasis of the courts on the role of fact in the worker classification cases. Greater willingness to lay down points of law, as suggested above, would assist in this area. A welcome development of this approach in the area of employment law can be seen in the application of the *Bottrill* decision in the recent case of *Smith*, discussed in paragraphs 3.97–3.101 above.

6.24 Where there are differences between taxation and employment law because special statutory provisions apply in one area but case law continues to apply in another, the justifications for these distinctions need to be considered by government across departments. If there are different objectives, then this needs to be discussed and clearly stated. If there is no good reason for the difference, then adoption of the special statutory provisions should be considered across all areas.

6.25 The new legislation on personal service intermediaries is an example of an area where action has been taken on taxation and NICs without full discussion of how it affects, or fails to affect, employment law. As a result it is possible that taxpayers will pay tax and NICs as if they were employees of the client company, but not benefit from most forms of employment protection *vis-à-vis* that client. They will normally be employees of the personal service company itself, but the weight that would be placed on the existence of the company by an employment tribunal is unpredictable. The veil might be lifted, as in *Catamaran Cruisers*, bringing employment law into line with taxation, but this would depend upon the employment tribunal's perception of the facts, and it is not known what, if any, account it would take of the tax and NICs position. If the personal service company became insolvent, an employment tribunal *could* decide, on the facts, that the worker was not an employee of that company at all. If he was also not an employee of the client, he would receive no redundancy pay. It is not clear that there is a coherent policy at work here, and an interdepartmental strategy would be desirable in the interests of clarity, certainty and justice.

[See paragraphs 3.94–3.101, 3.116–3.127 and 4.92–4.95]

**Comments are invited on the discrepancies between tax and National Insurance law on the one hand and employment law on the other. To what extent, if at all,**

**are practical problems and injustices created by any statutory and non-statutory differences? Is it agreed that the above steps, if taken by the courts and government, would be helpful?**

6.26 Under the new arrangements for administration and appeals, tax and National Insurance will now normally be in line as a matter of case law, though this was not always so in the past. There are areas of statutory difference, however, created by differences between the CATs Regulations and the equivalent taxation provisions covering areas such as agency, for example. These discrepancies were considered by the relevant government departments prior to merger and it was concluded that the problems did not warrant action at that stage. Given that there has now been a merger of the Contributions Agency and the Inland Revenue, however, it may be an appropriate time to review the discrepancies again and bring the provisions into line. There may be some areas where the difference between tax and NICs is maintained, as with actors, but this should be a policy decision rather than a failure to act. There may be groups of workers other than actors and divers who should be considered for this special treatment of being self-employed for tax purposes (so that they may deduct expenses) and employees for NICs purposes (so that they may be eligible for jobseeker's allowance).

**[See paragraphs 4.63–4.64 and 4.72]**

**Comments are invited on the question of alignment between tax and National Insurance and whether any practical problems are created by current discrepancies.**

6.27 The fact that NICs appeals will now be heard by the Tax Commissioners is welcome, but the legislation should make it clear that a ruling by the tax tribunal is binding for both tax and National Insurance purposes, whether or not both are explicitly addressed at the hearing (unless there are statutory differences or the issue in question is a different one). At present, there remains a risk that different bodies of Commissioners will reach different decisions in tax and NICs appeals, although administrative arrangements are in place to try to avoid this.

**[See paragraph 5.9]**

**Comments are invited on any practical experience of differences in approach by the Inland Revenue to tax and NICs and on whether a legislative provision as suggested would be practical and helpful.**

***Guidance to be given by the Inland Revenue and other government bodies***

6.28 In view of the complexity of the case law and statute on classification of workers, it is not surprising that the Inland Revenue has not found it easy to draw up simple yet comprehensive guidance on the case law. The publication of the Employment Status Manual (ESM) by the Inland Revenue on the internet is welcome,

but a guidance booklet, more detailed than IR56 but less overwhelming than the ESM, would be desirable. Examples, as found in the IR35 guidance, would be welcome. Ideally, this guidance should cover other areas of law as well as tax and NICs. The drawing-up of such guidance should be a cross-departmental exercise and areas of difference between the different types of classification should be explained as far as possible. Simply to state that there may be differences is to invite the view that the law is confused.

6.29 Industry-based guidance on status of the type available to television and film workers would be particularly helpful. This could build on the current project being piloted in the fashion industry, which involves eight government departments, and could give advice on employment protection as well as tax and National Insurance. A booklet to give guidance to groups that commonly have little access to advice, such as homeworkers, would be particularly welcome.

[See paragraphs 3.39 *et seq.*, 4.41 and 4.50]

**Comments are invited on the type of written guidance that might be found useful generally. Suggestions for any groups or sectors that might require specially tailored guidance are also welcome.**

6.30 The formalisation and clarification of the operations of the Status Officers for tax and NICs purposes are welcome. A useful further development would be the setting-down of a definite (though probably extra-statutory) time-frame for the giving of written opinions on employment status for general tax and NICs purposes, as has been done in relation to the personal service intermediaries legislation. Publication of more statistics and examples of status opinions might also be helpful.

[See paragraphs 4.105 and 5.13–5.18]

**Comments are invited on the usefulness and practicality of the suggestion for a time-limit for status opinion requests. Does experience suggest that unreasonable delays are occurring in obtaining opinions either in relation to personal service intermediaries or more generally on worker status issues? Would publication of example status opinions be considered a helpful way of monitoring the giving of status opinions and providing guidance to taxpayers?**

### **Wider issues for future research**

6.31 There are inherent differences between the employed and self-employed at each end of the worker status spectrum. It would not be possible or desirable to subject those at each end of this spectrum to identical rules for calculating, paying and collecting taxation and NICs. The rules could theoretically be brought closer together in some respects, however, and the level of NICs for the employed and self-employed could be more closely aligned. These questions have been alluded to, but not fully examined, in this paper.

### *National Insurance*

6.32 The problem of equity between the employed and self-employed raises fundamental issues about the National Insurance system, its contributory foundations and its move, in practice, towards being a pure tax. As noted in the Introduction, this is a topic now attracting a good deal of attention, and it requires further work in this context, as well as more widely.

**[See paragraphs 0.13–0.17]**

### *Cumulative PAYE and absence of universal tax returns*

6.33 The constraints imposed by the cumulative PAYE system and the fact that only a minority of taxpayers complete a tax return are also topics of great importance that require further research. Suggestions for alignment of rules on deductibility of expenses, for example, are likely to be met with the response that allowing employees to make a large number of deductions would be impractical and inconsistent with a system of cumulative PAYE in which only a minority of employees complete a tax return.<sup>3</sup> Further work is needed on the desirability and practicality of the cumulative PAYE system for the future and on whether there would be benefits to be gained by increasing the number of taxpayers required to make tax returns or even making this a universal requirement, as in other jurisdictions.<sup>4</sup> It must be noted, however, that current government policy relies upon delivering credits through the pay-packet and this policy objective would seem to be in conflict with a move away from cumulative PAYE and towards universal tax returns.

**[See paragraphs 0.18–0.20]**

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<sup>3</sup> For alternative approaches to dealing with the expenses problem, see Freedman and Chamberlain 1997, fn. 2 Introduction above, at p. 112.

<sup>4</sup> As the Keith Report, fn. 19 Introduction above, noted in 1983, the UK is out of line with other countries in not having universal tax returns (though note that in some other jurisdictions there is joint taxation of spouses so that not all individuals actually fill in a return). The report accepted that there were resource problems with moving to 100 per cent tax returns. There are also problems with the complexity of current UK tax returns. Nevertheless, as self-assessment settles down, this could be the time to investigate the potential benefits of more widespread tax returns. Not least, there is an argument that taxpayers should have more knowledge about their own tax affairs than they do now and the achievement of this aim would be assisted by requiring tax returns. See, generally, D. Hole, 'An annual tax return for all: problems and benefits', (1998) in D. Hole and J. Millar, *Options for the UK Tax Return System*, Joseph Rowntree Foundation, York.

### *Non-cumulative deduction at source*

6.34 One linked issue that does arise rather more directly from this paper, though it is also related to the way in which tax collection is administered, is that of deduction at source from non-employees. The proposal of the Keith Committee in 1983 to deduct tax at source from casual workers generally on a non-cumulative basis has been mentioned above. It has not met with enthusiasm in the UK, being rejected most recently in Lord Grabiner's report on *The Informal Economy*, as discussed in paragraphs 4.10–4.11 above.

6.35 The UK does, however, have a complex system of deduction at source from non-employees for the construction industry (the CIS). The industry has many complaints about the burdens imposed by this system and it seems unlikely that government would wish to extend deduction at source from non-employees whilst the CIS is facing criticism. On the other hand, arguably, a broader system of deduction at source could be more acceptable and less discriminatory than one targeted only on one industry. The new Australian PAYG system requires withholding tax to be deducted from any supplier of goods and services not able to provide an Australian Business Number (ABN) and so it is not industry-specific.

6.36 The Australian scheme is similar to that proposed by the Keith Committee under which tax would be withheld from every worker who could not produce a VAT number.<sup>5</sup> VAT registration would not be adequate for such a scheme to operate in the UK, since VAT registration has a high threshold. Various alternative registration schemes for the self-employed have been proposed but have not met with much support in the past.<sup>6</sup> Generally, requirements to register businesses have been *reduced* in recent years as a deregulatory measure.<sup>7</sup> Following the Grabiner Report, new businesses in the UK will now have to register their existence with the Inland Revenue more promptly than previously and this will be enforced by penalties.<sup>8</sup> But a system that required all persons receiving gross payments to provide a business number might not be politically acceptable and might be considered obtrusive and too heavy in compliance costs. On the other hand, once workers became used to such a requirement, it might be found acceptable. It would be valuable to monitor the Australian scheme and compare it with the UK CIS.

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<sup>5</sup> The Keith Report, fn. 19 Introduction above, at para. 6.3.4. The ABN is also used for goods and services tax purposes in Australia.

<sup>6</sup> The National Federation of the Self-Employed proposed a scheme under which registration would be conclusive of self-employment (referred to in Smith and Thomas 2000, fn. 91 Chapter 3 above, at p. 13).

<sup>7</sup> For example, the Business Names Register no longer exists and a Customs and Excise consultation paper on public access to the VAT Register published in 1995 was not enthusiastically received.

<sup>8</sup> Inland Revenue Press Release, *Help for New Businesses Registering for the First Time*, 17 October 2000, [2000] STI 1492.

6.37 A general requirement to deduct tax at source would, however, not avoid classification problems. The ABN is available only to those carrying on an enterprise, which must be defined. As we have seen with the CIS, deduction at source from non-employees does not remove the need to differentiate them from employees if the level of withholding tax is different, or if the employees and the non-employees pay different rates of NICs. Employment status would also continue to be important for some employment protection purposes. Deduction at source would be a measure aimed largely at preventing tax evasion rather than removing classification problems. It could be costly in terms of both administration and compliance. It would bring a measure of alignment but leave many problems unresolved.

**[See paragraphs 3.14 and 4.8–4.26]**

### *Neutrality between legal vehicles for business*

6.38 The use of personal service intermediaries and the legislation designed to counteract this are just one consequence of the lack of tax and NICs neutrality as between different legal vehicles for business. This lack of neutrality has much wider implications, which go far beyond the scope of the current paper. The problem may be increased by the introduction of the Limited Liability Partnership, which combines the tax treatment of a partnership with the commercial advantage of a measure of limited liability. The fact that different business vehicles are taxed differently makes it inevitable that taxpayers will take taxation into account as a factor when considering which business medium to use. Giving reliefs and allowances to those trading through one business form and not to others will increase the incentive to do this. Attempts by government to provide incentives for some types of business, which it perceives to be 'genuine', but not to others are likely to be very difficult to target. Attaching reliefs to particular business forms, such as companies only, will increase the incentive for all taxpayers to incorporate. Government may then try to counteract the use of incorporation by those it had not intended to benefit. Personal service intermediaries and the legislation designed to counteract them are an example of this somewhat circular approach. A thorough review of the relationship between taxation of different legal forms would go far wider than the personal service intermediaries problem but might provide a result preferable to piecemeal and operationally difficult legislation designed to tackle only one outcome.

**[See paragraphs 2.11, 4.84, 4.101 and 4.102]**

6.39 These wider issues require further work and monitoring. In the mean time, the issue of classification of workers will continue to be one of importance and worthy of attention.

## APPENDIX: DIFFERENCES IN TREATMENT BETWEEN EMPLOYED AND SELF-EMPLOYED

A1 This Appendix sets out some of the main differences in treatment between employed and self-employed workers for tax, National Insurance and employment law purposes. It does not purport to be a comprehensive treatment of any of these areas, but outlines some of the major differences so that the importance of classification of workers can be understood for the purposes of this paper.<sup>1</sup>

### Tax<sup>2</sup>

#### *Computing income*

A2 There are significant differences in the method of computing income as between the employed and self-employed. Employees are taxed on their ‘emoluments’ under Schedule E of the Income and Corporation Taxes Act 1988 (ICTA),<sup>3</sup> whilst self-employed traders and professionals are taxed on their ‘profits’ under Schedule D, Cases I and II.<sup>4</sup> Emoluments and profits are conceptually different and there are fundamental differences in the method of calculating these two forms of income. A taxpayer may be both employed and self-employed simultaneously in respect of different sources of income. In such a case, taxation on the income from each source will be calculated entirely separately since the Schedules are mutually exclusive.<sup>5</sup>

A3 Emoluments are generally wages or salary and bonuses, with the addition of benefits in kind, which were brought into charge initially by case law and thereafter by legislative provisions.<sup>6</sup> Payments are usually received on a regular basis and the main issues revolve around special payments, such as signing-on and termination payments and benefits. They are taxed when they are received or become due.<sup>7</sup> Profits have to be calculated from a starting-point of the accounting profits, so as to give a true and fair view, with some adjustments for tax purposes. The cash basis is no longer permitted even for professions, so an accruals basis is required for all (with the exception of barristers and advocates in the early years of practice).<sup>8</sup> Clearly, calculation of such

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<sup>1</sup> The differences are also discussed in Freedman and Chamberlain 1997, fn. 2 Introduction above.

<sup>2</sup> For more detail, see Tiley and Collison, fn. 7 Chapter 3 above.

<sup>3</sup> Section 19 ICTA 1988; Tiley and Collison, fn. 7 Chapter 3 above, ch. 6.

<sup>4</sup> Section 18 ICTA 1988; Tiley and Collison, fn. 7 Chapter 3 above, ch. 7.

<sup>5</sup> *IRC v Brander and Cruickshank* [1971] 1 All ER 36.

<sup>6</sup> Tiley and Collison, fn. 7 Chapter 3 above, at paras 6.39 to 6.117.

<sup>7</sup> Sections 202A and 202B ICTA 1988.

<sup>8</sup> Section 42 of the Finance Act 1998, qualified by section 43. The adjustments are those ‘required or authorised by law in computing profits for those purposes’. It is clear that there are areas governed by statutes, such as depreciation, which is governed by the capital

profits will need to be retrospective and take place at the end of some fixed period. Only revenue expenses may be deducted from Schedule D and Schedule E income, except for those deductions permitted under the capital allowances regime.

A4 Much discontent has focused on the differences in the rules on deductibility of expenses for the purposes of income tax.<sup>9</sup> The expenses rules are generally considered to operate more harshly in relation to employees, who cannot deduct general expenses unless they are expended '*wholly, exclusively and necessarily in the performance of the employee's duties*'.<sup>10</sup> This wording has been construed strictly and objectively by the courts and is also applied strictly by the Inland Revenue.<sup>11</sup> For example, employees are often not permitted to make deductions for their own expenses of working at home, training courses and books to keep themselves updated.<sup>12</sup> Travel expenses are required to be incurred *necessarily in the performance of the employee's duties* or to satisfy statutory tests relating to travel to temporary workplaces.<sup>13</sup> Employees' capital allowances are similarly restricted to those for machinery and plant wholly, exclusively and necessarily provided for use in the performance of the employment.<sup>14</sup>

A5 By contrast, the self-employed have fewer conditions for deduction, having only to show that money was laid out or expended '*wholly and exclusively for the purposes of the trade or profession*'.<sup>15</sup> The words 'wholly' and 'exclusively' are found in both the Schedule E and Schedule D provisions and are strictly construed in both contexts.<sup>16</sup> Nevertheless, the additional words in the Schedule E test have resulted in a stricter, more objective, test for employees. The difference in effect of these two provisions may be greater in practical application than on paper. In particular, the approach to apportionment of certain types of expenses seems more relaxed in the case of the self-employed.<sup>17</sup>

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allowances code. It is less clear whether and to what extent this provision is subject to case law principles: see Tiley and Collison, fn. 7 Chapter 3 above, at pp. 317 *et seq.*

<sup>9</sup> See the Codification Committee, *Report of the Committee on Codification of Income Tax Law*, (1936) Cmd 5131, HMSO, London; Radcliffe Committee, fn. 17 Introduction above; Institute of Taxation, *Representations on the Form and Administration of the Taxation System*, (1989) IOT, London. (For a recent proposal, see IOD paper 1998, fn. 17 Introduction above.)

<sup>10</sup> Section 198 ICTA 1988.

<sup>11</sup> For example: *Roskams v Bennett* [1950] 32 TC 129; *Brown v Bullock* [1961] 3 All ER 129; *Smith v Abbott* [1994] 1 All ER 673.

<sup>12</sup> This is a particular problem for employees whose work requires them to maintain or increase specialist knowledge. In 1955, the Radcliffe Committee, fn. 17 Introduction above, ch. 5 commented on the special problems of employees with professional status; this group has now widened, as more workers need specialist knowledge and skills.

<sup>13</sup> Section 198 (1A) ICTA 1988.

<sup>14</sup> Section 27 of the Capital Allowances Act 1990 (cars and cycles are an exception).

<sup>15</sup> Section 74 (1) (a) ICTA 1988.

<sup>16</sup> *Mallalieu v Drummond* [1983] 2 AC 861.

<sup>17</sup> Freedman 1996, fn. 52 Chapter 4 above.

A6 There are some instances in which employees may be more leniently treated by the tax regime than the self-employed – for example, under the rules for travel expenses.<sup>18</sup> Some benefits in kind are also expressly provided to be tax-free on policy grounds – for example, use of workplace nurseries<sup>19</sup> and sports facilities<sup>20</sup> – and these advantages are not available to the self-employed. For the most part, however, benefits in kind are caught, and the tax payable on cars provided by the employer, for example, has now increased to a level where employees often prefer to take a higher salary rather than the car. A self-employed person may often make deductions in relation to some or all of the costs of a car used in the business. It is sometimes stated that rules on pension contributions are more generous to employees than to the self-employed, but the reverse can also be true,<sup>21</sup> and some differences are inevitable, given the different types of pension provision, their complexity and the important policy considerations related to them. Much depends on the type of provision an employer is prepared to make, which is partly, but not entirely, influenced by tax rules, and on the pattern of the worker's career.

A7 It is important not to exaggerate the tax benefits of the self-employed. Some of the perceived advantages may be the result of the self-employed making deductions that are not permitted by law but that are not picked up by the Inland Revenue because not all accounts of self-employed taxpayers can be scrutinised. Employees have their tax payments on benefits policed by their employers and claims for deduction of expenses will be unusual and so carefully scrutinised. Even when the law is applied strictly, though, there is greater flexibility in deduction of expenses for a self-employed person and a sense of injustice amongst those employees who do incur non-deductible expenses.<sup>22</sup>

### ***Differences in income tax collection methods and timing***

A8 The different nature of the tax base for employees and the self-employed in part dictates the method of collection and timing of taxation. The method of collection, in its turn, influences the substantive rules. The strict rules on expenses for

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<sup>18</sup> Introduced in Finance Act 1998.

<sup>19</sup> Section 155A ICTA 1988.

<sup>20</sup> Section 197G ICTA 1988. For other exceptions to the charge on benefits in kind, see section 155 ICTA 1988 and Tiley and Collison, fn. 7 Chapter 3 above, at para. 6.99.

<sup>21</sup> IOD paper 1998, fn. 17 Introduction above.

<sup>22</sup> A particular sense of injustice may also be felt by employees who have related Schedule D business. They may find that they cannot deduct expenses under Schedule E for the reasons given above, but that they are also denied a deduction under Schedule D because they use the equipment on which the expenditure is incurred for the purposes of their employment as well as their Schedule D activity, so that it is not 'wholly and exclusively for the purposes of their trade' (*Mitchell and Edon v Ross* [1962] A.C. 813). This is another consequence of the Schedules being mutually exclusive, as discussed in para. A2 above.

employees, for example, are important in a system that attempts to collect tax from employees without requiring a tax return from them, in the majority of cases.

A9 In most systems, employees are taxed at source under a flat rate withholding tax. Under the UK pay-as-you-earn (PAYE) system, the employers administer a cumulative system, designed to collect the correct amount of tax on employment income as received on a current-year basis.<sup>23</sup> Tax and National Insurance contributions (NICs) are deducted regularly from each pay-packet under a system governed by the Income Tax (Employments) Regulations 1993.<sup>24</sup> An employer may be liable to interest if he fails to apply PAYE correctly at the right time.<sup>25</sup> Most employees do not fill in a tax return. In 1996–97, following the introduction of self-assessment, 9 million tax returns were issued, which cover around 25 per cent of the adult population.<sup>26</sup> As has been noted in the Introduction, the burdens imposed by the PAYE system and the regressive nature of those burdens are under current discussion.<sup>27</sup> The system works best in large firms and with a stable work-force. It is less well geared to casual workers with a number of employers in any one tax year, given its cumulative nature.<sup>28</sup>

A10 The self-employed, on the other hand, are taxed on the annual profits or gains accruing from their trade or profession under a self-assessment system, which requires them to submit an annual tax return. This may be seen as a disadvantage of self-employment by some individual taxpayers. The self-employed taxpayer may use an accounting year that does not coincide with the tax year. A current-year basis applies, but payments are made only twice a year (31 January and 31 July, with a balancing payment on the following 31 January). Thus the self-employed can have a timing advantage because they make only two payments and because they do not have to make up their accounts for a period that is identical to the tax year.

A11 Employees personally have fewer administrative burdens than the self-employed, but, as described above, since employers have heavy compliance burdens, there is no overall saving of compliance costs by virtue of employment. Under PAYE, employers are required to account for benefits in kind as well as salary and wages, and this can add to the complexity and cost of the exercise. Employers argue that a further

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<sup>23</sup> Section 203 ICTA 1988.

<sup>24</sup> SI 1993/744.

<sup>25</sup> There are only limited rights for the Inland Revenue to proceed directly against an employee and for an employer to recover from an employee when tax has been paid to the Inland Revenue but not deducted from the salary – see Whitehouse, fn. 42 Chapter 3 above, at paras 5.231–5.232.

<sup>26</sup> L. Chennells, A. Dilnot and N. Roback, *A Survey of the UK Tax System*, (2000) Briefing Note no. 9, Institute for Fiscal Studies, London, [www.ifs.org.uk/taxsystem/taxsurvey.pdf](http://www.ifs.org.uk/taxsystem/taxsurvey.pdf) (hereafter IFS Briefing 9).

<sup>27</sup> See para. 0.20 and footnote thereto. Employers are also required to administer statutory sick pay, statutory maternity pay and working families' tax credit schemes.

<sup>28</sup> The Bath Report, fn. 8 Introduction above; Report of the Select Committee on the Treasury (Sixth Report, HC 199/1998/9).

burden is imposed upon them by payment of the working families' tax credit through the pay-packet.<sup>29</sup> Government has announced its intention to extend the principle of payment of credits through the pay-packet with an integrated child credit and an employment tax credit for people without children, so this is a burden set to increase rather than diminish.<sup>30</sup> The compliance costs of tax collection may be a factor in the decision of some firms to use free-lance workers rather than direct labour.<sup>31</sup>

### ***Other direct tax differences***

A12 Other differences in the direct tax system as it relates to the employed and self-employed are structurally inevitable. For example, tax reliefs for employee share schemes are designed to create an incentive for employees, but also, in effect, turn those employees into entrepreneurs to an extent and will be utilised by entrepreneurs. Business capital tax reliefs are largely designed for those owning their own business. The reliefs are extended to share-owning employees in some circumstances, though not always to those owning shares in quoted businesses. Discussion of these reliefs and incentives is outside the scope of this paper, but they do highlight the blurring at the edges between employees and the self-employed, given the legal vehicles available for setting up in business. The existence of these reliefs may be a factor in deciding in what form to do business, where the taxpayer has that choice, though for many of the 'grey area' people described above, these considerations will not be an issue since no large amounts of capital are involved.

### ***Value added tax (VAT)***

A13 VAT is charged on taxable supplies of goods and services made in the UK by a taxable person in the course or furtherance of a business carried on by him.<sup>32</sup> A person carrying on a trade, profession or vocation is included in the definition of business (though it also goes wider than this).<sup>33</sup> Thus self-employed persons must register for VAT purposes, subject to certain thresholds.<sup>34</sup> VAT is not payable in respect of the services provided by an employee to his employer. Again, there is a compliance cost issue here<sup>35</sup> and efforts have been made to reduce the burden on

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<sup>29</sup> Report of the Select Committee on the Treasury, fn. 28 above.

<sup>30</sup> Inland Revenue Budget Press Release, *Tax and NICs Reform for Working Families*, March 2000, [2000] STI 381; L. Beighton, 'The making of tax policy', (2000) *Tax Adviser*, December, p. 16.

<sup>31</sup> See para. 2.17 and Chapter 4 above.

<sup>32</sup> Value Added Tax Act 1994 section 4.

<sup>33</sup> Value Added Tax Act 1994 section 47.

<sup>34</sup> Value Added Tax Act 1994 sections 3 and 94.

<sup>35</sup> C. Sandford, M. Godwin and P. Hardwick, *Costs and Benefits of VAT*, (1981) Heinemann, London.

smaller firms. Nevertheless, the compliance burden may provide an incentive to be employed for those who have the choice.

A14 The VAT considerations in relation to self-employment as opposed to employment are not straightforward. VAT registration can be an advantage where there are VATable costs on which input tax can be recovered by a registered trader. For the labour-only contractor over the threshold, working from home and with relatively few VATable expenses, however, his output tax payable to Customs is likely to be more significant than any input tax recoverable, and so VAT returns are likely to be merely an administrative burden. If an outside contractor instead of an employee provides services to an exempt business (for example, a bank), any VAT charged by the outside contractor will not be recoverable. Thus VAT considerations may sometimes pull against other tax considerations, by increasing the costs for an exempt business in using an outside contractor. In other trades, where the customer is a private individual who cannot recover VAT paid, classification of service providers as self-employed may be preferred, as it will minimise VAT liability. An example of this incentive in operation can be seen in the hairdressing trade.

A15 The current VAT registration threshold is £52,000 of taxable supplies.<sup>36</sup> This is to be increased in line with inflation and is at the highest level in Europe.<sup>37</sup> For many of those borderline workers discussed in this paper, therefore, VAT registration will not be an issue even if they are self-employed. Even for those above the threshold, there are provisions that allow small traders to file VAT returns on an annual basis rather than the usual quarterly basis and under a cash accounting scheme. The threshold for these two schemes is to be increased substantially to £600,000.<sup>38</sup> The government intends to consult on further simplifications, including a flat-rate scheme avoiding internal VAT accounting and paying VAT as a percentage of turnover, for small businesses with a turnover of under £100,000.

## **National Insurance<sup>39</sup>**

### ***Contributions***

A16 The tax distinctions between the employed and self-employed may be relatively small compared with the differences in National Insurance contributions. The NICs burden on the self-employed is generally lower than that on employees:

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<sup>36</sup> Value Added Tax Act 1994 Schedule 1, para. 1 as amended by SI 2000/804.

<sup>37</sup> Customs and Excise Pre-Budget Report Press Release, 1, 8 November 2000, [2000] STI 1600.

<sup>38</sup> Customs and Excise Pre-Budget Report Press Release, fn. 37 above.

<sup>39</sup> For a detailed discussion of NICs, see Tiley and Collison, fn. 7 Chapter 3 above, Part IX. The information on benefits used here is taken from Child Poverty Action Group, *Child Poverty Action Group Welfare Benefits Handbook 2000/2001*, (2000) London and from C. Emmerson and A. Leicester, *A Survey of the UK Benefit System*, (2000) Briefing Note no. 13, Institute for Fiscal Studies, London, [www.ifs.org.uk/taxsystem/benefitsurvey.pdf](http://www.ifs.org.uk/taxsystem/benefitsurvey.pdf).

rates are lower and there is no equivalent to the employer's contribution. The self-employed are not entitled to all benefits, but, even allowing for this, they contribute less to the National Insurance Fund than employees. This gap is narrowing, due to structural changes in the way NICs are being collected. At present, however, there are sufficient differences for classification as employed or self-employed to remain important for this purpose. The government estimate is that the cost of reduced contributions for the self-employed not attributable to reduced benefit eligibility was £3.3 billion in 1998–99.<sup>40</sup> For 1999–2000 and 2000–01, this figure is estimated to be £2.4 billion.<sup>41</sup>

A17 There are four main classes of NICs, as shown below.

**National Insurance contributions**

<b>Class of contribution</b>	<b>Payable by:</b>	<b>Giving entitlement to:</b>
Class 1	Employed earners (primary) and their employers (secondary)	All benefits with contribution conditions
Class 1A <sup>42</sup>	Employers of employed earners	No benefits
Class 2	Self-employed earners	All benefits with contribution conditions except contribution-based jobseeker's allowance and State Earnings-Related Pension Scheme (SERPS)
Class 3	Voluntary contributors	Widows' benefits and retirement pensions
Class 4	Self-employed earners	No benefits

A18<sup>43</sup> Class 1 contributions are subject to an earnings floor called the lower earnings limit (LEL). Earning the LEL or more is important in order to qualify for certain benefits. Employees only pay NICs if their weekly earnings exceed the primary threshold (PT). Those earning above the PT pay a rate of 10 per cent on earnings between the PT and the upper earnings limit (UEL). For income above the UEL, no

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<sup>40</sup> Tax Ready Reckoner and Tax Reliefs, (1999) HM Treasury, London, Table 7.

<sup>41</sup> Tax Ready Reckoner and Tax Reliefs, (2000) HM Treasury, London, Table 7.

<sup>42</sup> Class 1A NICs are payable by employers only, on most, but not all, taxable benefits in kind. They are payable at the same rate as that for secondary Class 1 contributions. For the sake of simplicity, they will not be discussed further here, although it is interesting to note that attempts to align NICs on benefits in kind with tax treatment of benefits in kind remain incomplete – see S. Bradford, 'Alignment, but not as we know it', (2000) *Tax Adviser*, December, p. 25.

<sup>43</sup> Text and table in this paragraph taken from IFS Briefing 9, fn. 26 above.

employee contributions are paid. Employers also pay NICs for each employee who earns over the secondary threshold (ST). Above that level, they pay at a rate of 12.2 per cent on earnings above the ST. The table below summarises the structure for 2000–01. The contracted-out rate is that paid where the employee is in a defined benefit pension scheme instead of SERPS. Different rates apply where the employee is contracted out into a defined contribution pension scheme.

**Class 1 NICs rates, 2000–01**

<b>Total weekly earnings (£)</b>	<b>Employee's NICs Standard rate</b>	<b>Employee's NICs Contracted-out rate</b>	<b>Employer's NICs Standard rate</b>	<b>Employer's NICs Contracted-out rate</b>
Below 67 (LEL)	0	0	0	0
67–76 (PT)	0	0	0	0
76–84 (ST)	10	8.4	0	0
84–535 (UEL)	10	8.4	12.2	9.2
Above UEL	0	0	12.2	9.2

A19 The 1998 and 1999 Budgets substantially improved and simplified the structure of NICs to remove ‘steps’ that resulted in disincentives to earning. As part of this planned change, from April 2001, the LEL will be raised to £72 a week. The PT will be aligned with the ST and the income tax personal allowance at £87 a week, and no tax or NICs will be paid below that level. The UEL will be raised to £575 a week, resulting in a substantial rise, well above the rate of inflation, for higher-paid employees.<sup>44</sup> The 12.2 per cent employer’s rate is to be reduced to 11.9 per cent, with contracted-out rates reduced accordingly.

A20 There have also been major changes for the self-employed, in the direction recommended by the Taylor Report.<sup>45</sup> Class 2 contributions are paid at a flat rate, which has been reduced from £6.55 to £2 per week for 2000–02. This has removed the entry fee into work, as was done for employees. Self-employed people with earnings below the annual small earnings exception – currently £3,825 p.a., to rise to £3,955 in April 2001 – can apply to be exempted from paying Class 2 contributions.

A21 Class 4 contributions are payable by self-employed individuals whose profits exceed the lower profits limit (£4,385 p.a. in 2000–01, to rise to £4,535 in line with the income tax personal allowance in April 2001). The NICs rate is 7 per cent for

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<sup>44</sup> Announced in the 1999 Budget and confirmed in the 2000 Pre-Budget Report.

<sup>45</sup> The Taylor Report 1998, fn. 3 Introduction above.

## TWO EXAMPLES<sup>46</sup>

### Higher-paid worker

*An employee with annual earnings of £50,000 in 2000–01 and his employer will pay NICs as follows (assuming he is not contracted out of SERPS):*

Primary Class 1 contributions on earnings between the PT (£3,952) and the UEL (£27,820) at 10%	£2,386.80
Secondary Class 1 contributions above the ST (£4,368) at 12.2%	£5,567.10
Total	£7,953.90

*A self-employed person with profit of the same level will pay NICs as follows:*

Class 2 contributions £2 × 52	£104.00
Class 4 contributions on profits between lower profits limit (£4,385) and upper profits limit (£27,820) at 7%	£1,640.45
Total	£1,744.45

### Lower-paid worker

*An employee with annual earnings of £10,000 in 2000–01 and his employer will pay NICs as follows (assuming he is not contracted out of SERPS):*

Primary Class 1 contributions on earnings above the PT (£3,952) at 10%	£604.80
Secondary Class 1 contributions above the ST (£4,368) at 12.2%	£687.10
Total	£1,291.90

*A self-employed person with profit of the same level will pay NICs as follows:*

Class 2 contributions £2 × 52	£104.00
Class 4 contributions on profits above lower profits limit (£4,385) at 7%	£393.05
Total	£497.05

profits above the lower profits limit and below the upper profits limit. This rate rose from the previous 6 per cent, but is still a lower rate than envisaged by the Taylor Report.<sup>47</sup> For 2000–01, the upper profits limit is £27,820 p.a., but this will rise in April 2001 to £29,900. Above the upper profits limit, no further contributions are paid. The rise in the upper profits limit is in line with the rise in the UEL for Class 1 contributions. There has been a marked rise in this limit since 1999 – in the government’s words, ‘to ensure a fair base’ for contributions. This term is one that is

<sup>46</sup> First example adapted from Tiley and Collison, fn. 7 Chapter 3 above, at p. 1458.

<sup>47</sup> The Chancellor made a point of this: see Budget Statement, 9 March 1999.

more clearly associated with a tax than a contributory system. There is, nevertheless, a long way to go before equality of contributions between employed and self-employed is achieved, as can be seen from these figures, particularly as there is no UEL for employers. The combined rates for employees and employers remain significantly higher than the rate for the self-employed, and the incentive to be self-employed increases as income/profits rise.

### ***Benefits***

A22 Non-contributory benefits, funded from general taxation, are available to the employed and the self-employed equally.<sup>48</sup> Some, but not all, of these are means-tested. In addition, as seen in the table at paragraph A17 above, Class 2 contributions bring with them entitlement to most contributory benefits. This does not include entitlement to **SERPS**, but many employees are contracted out of this scheme in any event.<sup>49</sup> It does include the basic state pension, subject to contribution record. Contribution-based jobseeker's allowance is the other main benefit not available to the self-employed. Class 4 contributions do not count towards any benefit entitlement but are nevertheless income of the National Insurance Fund used for the payment of benefits.

A23 As mentioned, the self-employed are not entitled to contribution-based, non-means-tested **jobseeker's allowance (JSA)**. This is the main reason for actors wishing to pay Class 1 contributions, as discussed in Chapter 4 above. The same consideration would apply to homeworkers and other lower-paid workers. They may be below the PT for NICs, or only just above it, so that for a small NICs payment they could obtain a benefit that could prove important to them if they were classified as employees and their employers made the correct returns and payments. For some more highly paid self-employed, however, loss of JSA is not a major concern. For them, the saving in contributions far outweighs the potential loss of JSA. In any event, contribution-based JSA is only payable for six months rather than a year, as was the case with unemployment benefit. In 2000–01, an employee with a sufficient contribution record will receive a maximum of £52.20 per week. Self-employed earners must rely on the non-contributory means-tested JSA. This can equal or exceed the contribution-based JSA in some circumstances, since it reflects the needs of the claimant's family. On the other hand, because family income is taken into account, a self-employed person with an earning spouse will not normally be eligible for contribution-based JSA, whereas an employee would receive non-means-tested JSA.

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<sup>48</sup> Non-contributory benefits include the following (where asterisk denotes means-tested): Category D retirement pension; child benefit; income-based jobseeker's allowance\*; invalid care allowance; disability living allowance; industrial injuries benefit; attendance allowance; guardian's allowance; Social Fund\*; cold weather payments\*; housing benefit\*; council tax benefit\*; income support\*; family credit\*; disability working allowance\*.

<sup>49</sup> Current plans on pension reform also erode the importance of SERPS.

A24 Employees over the LEL and satisfying various conditions about periods of employment will be entitled to **statutory sick pay (SSP)** of £60.20 per week in 2000–01, for a maximum of 28 weeks. This is paid by the employer, but much of the cost is reclaimed from the government. A self-employed person does not receive SSP, but receives **incapacity benefit** of £50.90 per week for 28 weeks instead if they have made sufficient Class 2 contributions. Incapacity benefit is paid at a higher, taxable short-term rate to employed and self-employed from weeks 29 to 52 and thereafter at a long-term taxable rate. From April 2001, incapacity benefit entitlement will be partially means-tested for those with pension income.

A25 The test for incapacity benefit can be tougher than that for SSP. The test for SSP is that the worker is ‘incapable of doing work which [he] could reasonably be expected to do under the terms of [his] contract because [he] has a specific disease or bodily or mental disablement’ or treated as being incapable for work. For incapacity benefit, the test is either the ‘own occupation test’, which is similar to the test for SSP, or the ‘personal capability assessment’. The latter test applies where the claimant does not have a regular occupation when he falls ill and also for all claimants after 28 weeks. It is an objective test that will assess whether the person is capable of performing prescribed activities, without reference to the person’s last job or usual job.

A26 An employed earner is entitled to receive **statutory maternity pay (SMP)** from her employer subject to certain service requirements. To qualify, her earnings must be above the LEL. SMP lasts for 18 weeks. For the first six weeks, it is paid at 90 per cent of the claimant’s average weekly earnings (if higher than £60.20), and for the remaining 12 weeks, it is paid at £60.20 a week. Since August 2000, **maternity allowance (MA)** has been relaxed substantially and is now more freely available to the self-employed than previously. This was announced in the 1999 Budget as a quid pro quo for increasing the self-employed NICs and should assist groups of workers such as homeworkers. It is payable to women unable to claim SMP and is non-contributory, but it does require the claimant to have been employed or self-employed (not necessarily with the same employer or continuously) for at least 26 weeks in the period of 66 weeks up to and including the week before the baby is due. The earnings condition requires that average earnings from all employment are at least £30 a week. MA is payable for up to 18 weeks. If average weekly earnings are at least equal to the LEL, the standard rate of £60.20 will be payable for the full 18 weeks. If average weekly earnings are less than the LEL but at least £30 a week, the claimant will receive variable-rate MA (being 90 per cent of the claimant’s average weekly earnings) up to a maximum of the standard rate.

A27 Entitlement to **widow’s payment, widowed mother’s allowance** or **widow’s pension** is dependent on adequate NICs having been paid, but these may be of Class 1, 2 or 3.

### *Compliance costs and merger*

A28 As can be seen from this brief description, the issues surrounding collection of NICs and entitlement to benefits are very complex. The contributory principle survives and requires the collection and maintenance of detailed contribution records. At the same time, the link between contributions (and particularly the level of those contributions) and benefits is becoming less clear and the progressive rates of NICs make them look more akin to taxation. The compliance cost on employers of collecting both the correct amount of NICs and tax, applying similar, but not identical systems, is high, and this has led to calls for a full merger of the tax and NICs systems and even for a review of the contributory principle. As discussed above, full integration in the near future seems unlikely, but the pressure is mounting.<sup>50</sup>

### **Employment rights and status<sup>51</sup>**

A29 In the past, status as an employee has been crucial to those seeking access to employment protection. As seen in Chapter 4,<sup>52</sup> recently certain types of employment protection have been extended to a wider range of workers than those who would be defined as employees under the case law discussed in Chapter 3 above. Other protection remains confined to employees.

A30 In addition to the status requirement, there is often a continuity of employment requirement. This presents claimants with a difficulty in many cases and explains why some casual workers seek to show the existence of an ‘umbrella’ employment contract, as in the *Carmichael* case.<sup>53</sup> It has been pointed out that there is a degree of duplication between the mutuality test for employment, discussed in Chapter 3, and the statutory tests for continuity of employment. In effect, there is a double threshold.<sup>54</sup> The continuity requirement is now easier to satisfy than previously, however, since the government was forced by decisions of the European Court of Justice to abolish the requirement for employees to have worked at least 16 hours in a week for the service to count towards this continuity requirement.<sup>55</sup> There are also provisions in the Employment Rights Act 1996 permitting the combination of short periods of employment into a month of continuous employment, and certain weeks of absence count for continuity purposes under the statutory provisions.<sup>56</sup> EU pressure has also resulted in the reduction in length of the qualifying period of continuous employment

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<sup>50</sup> See Introduction above.

<sup>51</sup> For up-to-date accounts of employment law, drawn upon for this section, see: Selwyn, fn. 92 Chapter 3 above; B. Willey, *Employment Law in Context*, (2000) Financial Times Prentice Hall, Harlow; and R. Painter, A. Holmes and S. Migdal, *Cases and Materials on Employment Law*, (2000) 3<sup>rd</sup> edition, Blackstone Press, London.

<sup>52</sup> Paras 4.107–4.117 above.

<sup>53</sup> See para. 3.85 above.

<sup>54</sup> The DTI employment status report, fn. 23 Introduction above.

<sup>55</sup> Employment Protection (Part-time Employees) Regulations SI 1995/31.

<sup>56</sup> Sections 210–219.

needed to acquire rights. This may lead to the need for ‘umbrella’ contracts being lessened.<sup>57</sup>

A31 Employees are entitled not to be dismissed without notice. Failure to provide due notice can lead to a claim for wrongful dismissal. Under the Employment Rights Act 1996, employees are entitled to a minimum period of one week’s notice after one month’s continuous employment and of two weeks’ notice after two years’ continuous employment, increasing by one week each year up to a maximum of 12 weeks after 12 years’ continuous employment. There can be contractual rights over and above this.

A32 Employment status is necessary for protection against **unfair dismissal**.<sup>58</sup> A dismissal (whether with or without notice) will be unfair if no fair reason was given, if the disciplinary process leading to dismissal does not conform to standards of fairness and natural justice, or if the decision to dismiss is not reasonable in all the circumstances. The Employment Rights Act 1996 sets out in more detail what is required. It is possible to contract out of unfair dismissal protection in relation to fixed-term contracts in some circumstances.

A33 Only one year of continuous service is needed to benefit from the general protection against unfair dismissal.<sup>59</sup> The right not to be dismissed for an inadmissible reason (related to discrimination law) or on the grounds of pregnancy or childbirth does not depend upon length of service. If the continuous service requirement is not satisfied, the only remedy, if any, may be for wrongful dismissal.

A34 There are three remedies for unfair dismissal: reinstatement, re-engagement and compensation. Compensation consists of a basic award and a compensatory award. There may also be an additional award and a special award in limited circumstances. The basic award takes account of a number of factors, including length of continuous service.<sup>60</sup> The compensatory award is more discretionary, but is subject to a limit, recently raised to £50,000 by the Employment Relations Act 1999.

A35 One reason for dismissal that may be fair under the unfair dismissal legislation is **redundancy**. Two years’ continuous employment is still necessary to be able to claim statutory redundancy pay.<sup>61</sup> The payment is calculated according to a formula that includes factors such as the employee’s age and length of service. Where an employer is insolvent, redundancy payments may be claimed from the DTI. As we have seen in Chapter 3, however, there have been attempts to deny this payment to

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<sup>57</sup> Collins 2000, fn. 11 Chapter 1 above.

<sup>58</sup> Section 94(1) of the Employment Rights Act 1996.

<sup>59</sup> Section 108 Employment Rights Act 1996 amended by the Unfair Dismissal and Statement of Reasons for Dismissal (Variation of Qualifying Period) Order 1999/1436.

<sup>60</sup> Sections 113–124 of the Employment Rights Act 1996.

<sup>61</sup> Section 155 of the Employment Rights Act 1996.

owner/directors of insolvent companies on the grounds that they are not employees for this purpose.<sup>62</sup>

A36 Employment status is also required for **guaranteed pay**,<sup>63</sup> **statutory sick pay**, **maternity leave**<sup>64</sup> and **statutory maternity pay** under the Social Security and Contributions Act 1992. Continuous employment of varying lengths is required to benefit from these rights.

A37 Extended definitions of employment apply under sex, race and disability discrimination statutes, as we have seen in Chapter 4 above. Those under contract personally to execute work or labour are included, but this definition does not cover all self-employed persons.

A38 The National Minimum Wage Act 1998 sets out the procedures for enforcing a national minimum wage for all workers as defined in paragraph 4.110 above, as extended for homeworkers and agency workers as explained in paragraph 4.116 above. These extended interpretations continue to incorporate the issue of whether there is a contract of employment and, though other workers are also included, there remain questions about definitions. Other statutes that refer to workers for at least some purposes include the Employment Rights Act 1996, the Employment Rights (Dispute Resolution) Act 1998, the Working Time Regulations 1998 and the Part Time Workers (Prevention of Less Favourable Treatment) Regulations 2000. The last of these could be particularly helpful for some of the non-standard groups of workers referred to throughout this paper, requiring them to be paid and receive benefits no less favourable than those paid to full-time workers, though on a pro-rata basis. The express extension in the National Minimum Wage Act 1998 of workers to include homeworkers has not been adopted in these Regulations.

## **European Community law**

A39 For the purpose of co-ordination of social security provisions for migrant workers within European Community law, persons are identified as employed or self-employed by reference to the categorisation applied to them by the national social security schemes of the Member States concerned.<sup>65</sup> This therefore assumes the existence of these categories in national law. It has been argued that any proposals to depart from this distinction in UK law would make the EC Regulations unworkable,

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<sup>62</sup> See paras 3.97–3.101 above.

<sup>63</sup> Section 28 of the Employment Rights Act 1996 (entitlement to pay even where there is insufficient work).

<sup>64</sup> Sections 71 and 75 of the ERA as amended by the Employment Relations Act 1999 and the Maternity and Parental Leave Regulations 1999.

<sup>65</sup> Regulation 1408/71 as amended.

though presumably this could be dealt with by amendment, since each Member State has different provisions set out in the Annex to the Regulations.<sup>66</sup>

A40 More generally, Article 39 of the EC Treaty refers to freedom of movement for workers and Article 43 (freedom of establishment) refers to self-employed persons. These terms may not be defined by reference to the national laws of the Member States but have a Community meaning, otherwise the purposes of the Treaty could be frustrated by the exclusion of categories of person.<sup>67</sup> Both Articles are based on the same principles, however, so that persons engaged in some sort of genuine economic activity will normally be protected in one way or the other.

A41 In *Lawrie-Blum*, the Court stated that the ‘essential feature of an employment relationship is that for a certain period of time a person performs services for and under the direction of another person in return for which he receives remuneration’. Therefore, in *Asscher v Staatssecretaris*,<sup>68</sup> it was held that a company director and sole shareholder of a company was not an employee for EC law purposes since he was not under the direction of any other person or body that he did not himself control.<sup>69</sup> It is for the national court to decide whether there is such subordination in the light of the considerations of fact and law in each particular case. To date, there has been no influence from these EC cases on UK domestic law, but some future influence is possible if EC issues begin to arise in domestic courts and become part of the consideration of law and fact that the judges must take into account in deciding worker status.

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<sup>66</sup> The DSS 1994 report, fn. 80 Chapter 3 above.

<sup>67</sup> *Levin v Staatssecretaris van Justitie* [1982] ECR 1035; *Lawrie-Blum v Land Baden-Wurttemberg* [1986] ECR 2121.

<sup>68</sup> Case C-107/94 ECJ [1996] STC 1025.

<sup>69</sup> Though he was taxed as an employee under the national law of the Netherlands. This did complicate the case: see J. Avery Jones, ‘Further thoughts on non-discrimination in Europe following Asscher’, [1997] *British Tax Review* 75.