

THE WELFARE REFORM AND PENSIONS BILL

REGULATORY IMPACT ASSESSMENT

**NATIONAL INSURANCE: SERVICE PROVISION THROUGH
INTERMEDIARIES**

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Inland Revenue

Regulatory Impact Assessment (Revised October 1999)

NATIONAL INSURANCE: SERVICE PROVISION THROUGH INTERMEDIARIES

Summary

1. This Regulatory Impact Assessment refers to the policy of stopping the avoidance of National Insurance Contributions by means of intermediaries such as service companies. The policy is provided for in clauses 71 and 72 of the Welfare Reform and Pensions Bill, currently going through Parliament.
2. The Government has put forward amendments to the Bill, at its Lords Report stage, to reflect changes to the proposed method of implementing the policy. Individuals in circumstances which would be treated for NIC purposes as employment, if it were not for an intermediary such as a personal service company, will have to pay National Insurance Contributions on the income received by the intermediary in return for their services, after allowing for certain specified deductions. This will ensure that they pay a fair share of NICs compared with those directly employed.
3. The main effect of the changes on compliance costs is to remove any costs from the clients of the service companies, who under the original proposal would have been obliged to deduct NICs (and tax) from payments made to the service companies for the workers' services. The Regulatory Impact Assessment issued in May 1999 assumed that the effect of these rules would be to make operating through an intermediary so unattractive in practice that they would cease to be used in cases to which the new rules would apply. The compliance costs in that Assessment were therefore based on the assumption that clients would incur the cost of taking the workers onto their payrolls as direct employees.
4. Following consideration of responses to consultation since the Budget, the Government has accepted that both workers and clients see advantages in working through intermediaries, in terms of the ability to take on staff for relatively short periods in a flexible way without taking them onto the payroll. The Government does not want to take away this flexibility, and the revised proposals are intended to make the choice whether to work through an intermediary or as a direct employee broadly tax and NIC neutral. If the worker pays tax and NIC on a basis which is fair in comparison with a direct employee, he or she should be free to choose to operate through an intermediary for other reasons.
5. Because the choice whether to operate through an intermediary under the revised rules will be tax and NIC neutral, this Regulatory Impact Assessment does not attempt to predict what the overall response will be. It presents estimates of the compliance costs on the basis that 25, 50 and 75 per cent of the current population of intermediaries *affected by the new rules* decide to continue.

6. Under the revised proposal, if the worker chooses to continue to operate through an intermediary, the assumed additional recurrent unit costs compared with the current situation are:
 - Left unchanged for service companies used by the highest paid group of workers, increased by £100 a year for those earning between £35,000 and £100,000 (from £600 to £700 per year) at the top of the range; and similarly increased by £50 a year for lower paid workers (from £300 to £350 per year);
 - Costs for clients are the same as now, where the worker continues to work through a service company - but greater if clients take the worker on as an employee. Under the earlier version of the proposal clients would have faced higher compliance costs in either case;

There is also an additional compliance cost of between £1.5 and £8 million imposed on a wider range of companies which are not caught by the new rules but may incur costs in connection with the change.
7. At the lower end of the estimated range of costs the **additional annual compliance cost is broadly speaking negligible**, though if 75% of workers choose to continue to operate through service companies, it would be about £1 million. At the upper end the additional annual compliance costs are **some £3, £6 or £9 million higher for the three scenarios (25%, 50%, 75%), respectively**.
8. There will also be a one-off cost of between **£15 and 20 million** (depending on the percentage of companies continuing) in the first year to reflect costs involved in learning to operate the new rules and taking advice on their operation, and establishing their status. This may include in some cases the costs of negotiations with the Inland Revenue and appealing against Revenue decisions.

Introduction

9. In the 1999 Budget, the Chancellor announced that changes would be introduced to counter tax and National Insurance avoidance in the area of personal service provision. In September 1999, after an extensive period of consultations the Revenue brought forward revised proposals for countering the loss. The revised proposals generally move the burden of compliance off clients and replace the registration scheme and control test with a simpler and better understood set of rules based on the existing self employment tests. The revised RIA now compares burdens on the three bases: current, the budget (IR35) and new proposals.
10. There has been an increase in the practice of hiring people through intermediaries, such as service companies, so that they can achieve the financial advantages offered by a corporate structure.
11. In the absence of an intermediary, the relationship between a client and a worker would determine the worker's employment status for the purposes of both tax and National Insurance. The liability would then be assessed according to whether the person was employed or self-employed. However, when a worker is engaged through one or more intermediaries which have separate legal identities, any direct contractual relationship between client and worker is usually broken. The most common form of intermediary used is a service company.

Issues and objectives

12. The new proposal will restore fairness by ensuring that, where an individual is engaged by a client through an intermediary and that relationship has the characteristics of employment, then the worker will pay tax and National Insurance Contributions (NICs) on the money received from the client, after allowing for a limited range of expenses, on the same basis as an employee. The service company will be liable for the corresponding secondary NICs.
13. This objective will be achieved by considering the self-employment tests that will be applied to the substance of the relationship between the client and the worker. Where those tests indicate that the relationship would have been that of employee and employer had it not been for the presence of one or more intermediaries, then the new proposals will apply.
14. The assessment below concerns the costs and benefits to business of complying with the new rules. The extra NICs revenue from this provision is estimated at around £220m a year.

Risk Assessment

15. If the proposed changes are not implemented there will be a number of consequences:
 - individuals who are able to manipulate their income in this way reduce their NICs liability compared to those who work directly to the employer. The loss of revenue to the National Insurance Fund is increasing and is, in effect, borne by other individuals and employers who do pay their fair share;

- the number of service companies and other intermediaries used to disguise employment will continue to rise significantly. The number of service companies is estimated to have risen from the range of 20-50,000 to 33-66,000 in the past few years. Furthermore, with the increased incentives for small and medium companies, it is anticipated that the rate of growth would accelerate. This could mean that the effect of the targeted incentives provided to encourage entrepreneurs was diluted;
- people who work through intermediaries can lose their employment rights under the law. The number of such workers would continue to rise;
- parallel measures are being proposed for income tax through PAYE from 6 April 2000. If the NIC measures are not implemented, the two systems would be out of line, which would impose an extra administrative burden on business.

Options

16. Several options were identified. The key options are summarised below.

- *Do nothing.* Individuals have a right to organise their affairs in the most efficient manner for tax and NICs. However, the risks indicated above would continue; we think this is unacceptable and unfair to those who do not organise their affairs in this way.
- *Introduce a general anti-avoidance provision to cover the use of intermediaries that disguise employment.* When we consulted on similar proposals before, there was opposition to general anti-avoidance measures in principle. Also, this would not be an efficient way of deterring these arrangements, given the numbers involved and the uncertainty such a provision would introduce.
- *Bring dividend income into NIC liability.* Workers engaged through intermediaries often take the bulk of their remuneration in the form of share dividends, which are not liable for NICs. It was therefore considered whether dividends should be brought into NIC liability to restore the parity. We concluded that it would be extremely difficult to devise effective legislation which could define dividends in such a way so as to exclude dividend income which originated from genuine enterprise and investment.
- *Outlaw the use of intermediaries in the provision of personal services.* This would unnecessarily constrain the operation of the labour market and might discourage genuine enterprise. We recognise that there can be advantages for the flexibility of the labour market in allowing workers to operate through intermediaries if they wish to do so, as long as they pay a fair share of tax and NIC.
- The recommended option – introduce legislation which ensures that the worker pays tax and National Insurance as an employee, on the amount received in respect of his services less certain expenses. It was concluded that this would be the fairest way to restore the intended use of the National Insurance legislation.

Benefits

17. The benefits of the proposed measure are that:

- it will protect the National Insurance Fund from a loss of revenue. It is estimated that the additional revenue to the National Insurance Fund from 2002 will be around £220m a year;
- it will allow flexibility to individuals and service companies to operate as personal service companies if that is the norm in a specific industry;
- it will restore fairness in competition by ensuring that employers who engage employees through an intermediary such as a service company do not enjoy more favourable NIC treatment than those who employ workers direct; and it will make the choice whether to operate through an intermediary or as a direct employee broadly tax neutral. By removing the substantial financial incentive to operate through an intermediary, we would expect it to make the use of intermediaries by some categories of worker – for example, those with a long-term relationship with a single “employer” - less attractive. If these workers return to direct employment, they will gain the benefit of employment protection legislation.

Business sectors affected

18. Although this measure will apply to all forms of intermediary, service companies are the most common form of intermediary now. The following compliance costs are based on an analysis of service companies. There are currently an estimated 33,000 to 66,000 service companies which have engagements characteristic of employment. The Revenue is aware that there are tens of thousands of other service companies without these characteristics¹. These figures were reached by examining the proportion of high payouts (the ratio of dividends to profits) in all small companies. A high payout rate in dividends is taken as indicating a service company that would be caught by the new rules. Even so, this is still subject to considerable uncertainty.
19. Our analysis suggests that, on average, there are 1½ directors or employees for each service company. On this assumption, there is a total of 50-100,000 people who will be affected directly by the new rules. Using the central estimate, that makes 50,000 service companies and 75,000 workers – nearly ¼ per cent of the working population. Because of uncertainty over the numbers of companies produced by examining the payout ratios, a range of 33,000 to 66,000 with a central estimate of 50,000 for the number of service companies has been adopted.
20. Table 1 below sets out the numbers of companies likely to be affected by the measure, split into broad sectors. This is based on internal Revenue analysis.

Table 1: Number of service companies likely to be affected, by sector

Broad industry group	Number in 000s
Manufacturing	6

¹ Other outside commentators have estimated very high numbers for personal service companies without distinguishing between the total affected and the total not affected.

Construction	4
Distribution, hotels, catering and repairs	5
Transport and communication	1
Banks, finance and professional services	10
Business services	14
Other/unclassified	6
Real estate	3
Recreational services	1
TOTAL	50

21. The companies have been analysed and divided according to the workers' earnings:
- A** High earners, such as senior executives, footballers and entertainers. Typical earnings would be over £100,000 a year;
 - B** Includes professionals in the oil and computer industries, and also includes management consultants. Earnings are estimated to be between £35,000 and £100,000 a year, though typically around £60,000;
 - C** Includes builders, teachers and secretaries. Earnings average £20,000 a year.
22. There is also a wider range of companies who will be affected. These businesses, labelled below as group **D**, will incur costs, for example, in establishing whether the new rules apply to them. However, because it is difficult to predict behavioural effects, it is not possible to give a detailed breakdown.

Compliance costs for a typical business

23. Under the new proposal personal service companies will have more choice, and so companies that would have wound up under IR35 may now continue. Thus compliance costs² fall into three basic categories: those incurred by continuing as service companies; those incurred by reverting to direct employment; and those

² a) These NICs measures will be mirrored by tax legislation. So the costs shown are the administration costs of complying for both tax and NIC liability.

b) Because of their corporate structure, service companies incur business, not individual, compliance costs. The compliance costs to the service companies are treated as business compliance costs in the same way as the compliance costs to the client for employment or attending to other rules.

incurred by other companies or clients/agencies in operating the rules, from learning the new rules and adapting, which are as follows.

- It is expected that many businesses will choose to retain a service company basis and accept the compliance burden of operating with the liability for tax and NICs in their service company. Therefore, the change in compliance costs will be the difference between their present costs of operating a service company and the new costs of calculating the amount of salary on which they must pay NICs and PAYE tax plus any one-off, or continuing, costs of advice in checking with the Revenue and deciding what their status is. Some of this status advice may need to be ongoing as short term contracts end and different contracts begin.
- It is thought that some businesses facing new liability for tax and NICs will wind up their service company and go into direct employment with their client. Therefore, the business compliance cost will fall onto the client and what were the business compliance costs in the service company will cease. Individuals who enter direct employment will no longer be responsible for their business compliance costs, but will face only a much reduced personal compliance cost as employees. In such cases the clients will incur the compliance costs of taking on employees.
- A wider category, shown as Group D, includes companies that are not directly affected under the new rules (ie outside the borders of Groups A to C plus their clients and the various agencies), but will still face compliance costs: e.g. the cost of professional advice to confirm status. There are also industry wide learning costs associated with the legislation, and other tax planning costs. Group D covers these wider compliance costs.
- The compliance costs for clients were an issue under IR35, as clients would generally have incurred costs in respect of groups A, B and C. Under the revised proposal burdens on clients are removed, at least to the extent that the service company remains, otherwise clients pick up the burdens of direct employment from those leaving the company status. If individuals wish voluntarily to retain the flexibility of company status the compliance burdens stay in the small personal service companies and not with their clients which are generally much larger businesses.

Compliance costs – direct employment by the client

24. Business compliance costs are made up of payroll type costs, accountancy costs and related legal contract costs. If individuals previously engaged through intermediaries disguising employment are put on the client's payroll, then the client will incur additional payroll costs. Adding someone to the existing payroll of an employer would cost up to £75 (less for medium and large employers) for the first year, and maintenance costs thereafter are estimated to be between £14 and £20 a year for a large employer and up to £300 per year for a small employer.³
25. At the bottom end of the scale the cost of drawing up a contract of service for direct employment for those in Group C who return to direct employment could be

³ Source – The Bath University Report – “ The tax compliance costs for employers of PAYE and National Insurance in 1995/96”.

low. At the other end of the scale this is likely to be a substantial cost for very high earners, where specialist legal advice will be sought, as in Group A. Such costs will probably add to the already high costs which would be involved in drawing up the contract with the intermediary under the current situation mainly in the area of termination of direct employment. For professionals in Group B and some others in A, costs could be a lot lower, where the employer can use standardised industry contracts. In addition to legal costs it is estimated that the accountancy tax advice in drawing up a new contract for someone in group A is substantial, and could be well above the base level accountants' cost for company registration under the current situation. Judgements on these effects are given in the unit costs in Annex Table 1, and the changes can be compared with Table 2 for the current situation.

Broad tax/NICs neutrality under the new rules

26. Where there is a broad tax/NICs neutrality for the individual between the payment of a net salary by the client and the payment of an equivalent net salary within the service company, the compliance costs of operating as a service company will influence the incentives to continue to work through the company or to work directly. The 5% allowance for expenses is designed to relieve some of the costs in the company. These decisions about continuation may well allow different personal views about the balance of advantage within a broadly neutral package, and may also vary from industry to industry depending on customary contractual practice.

Compliance costs – within the service company

27. If individuals who work through intermediaries take more of their income from the intermediary in the form of salary, instead of receiving dividends, then the service company may well incur additional compliance costs in operating PAYE and NIC deductions on salary payments. These costs will be related to the pay frequencies of the employment and the end of year costs in signing off that the earnings from the relevant contracts have been all paid away, less the 5% allowance, through PAYE/NICs. The extent of the work in accounting properly within the service company will depend on the mixture of relevant contracts and any changes in contracts during the year. On the one hand there are extra burdens in handling the payroll, but on the other hand there are offsetting savings in accountancy work from not paying dividends since there is unlikely to be any capacity to pay dividends, where the intermediary has no other form of income.
28. For many small service companies with just one relevant contract and no changes during the year, it is likely that the compliance costs would not be much different from the costs applying now. On balance the accountancy savings from not paying dividends through the year are probably not quite enough to cover the extra work in paying monthly wages subject to PAYE/NICs and calculating the minimum salary at the end of the year. This is assessed as a typical additional cost of about £100 to £150 per year for Group B. However, if there are a lot of short term contracts with advice/opinions needed from the IR network, then it is likely that accountants charges for these service companies will be markedly higher than now. There will probably also be a one-off charge in the first year for advice

related to the new regime, and this is thought of as varying with the turnover of the service company.

Compliance costs – in Group D

29. Besides the companies in groups A-C a wide range of companies will potentially be affected by the new requirements. This wider category is shown as group D. Businesses in this group will retain their service company arrangements, because they can demonstrate that they satisfy the self employment test. In some cases they will incur professional costs in establishing whether the new legislation applies to them. It is likely that some businesses will choose to seek further professional advice as to whether the proposal has implications for them and how they might escape those implications. The Revenue guidance will seek to minimise the need for professional advice – but it is likely that some businesses to whom the new legislation will not directly apply may still take advice during the first year of introduction of this measure, and in subsequent years as contracts change.
30. The total additional cost for this group of ensuring that they comply with the new rules is estimated to be between £1.5m and £8m. This is subject to particular uncertainty. In view of the nature of how such costs for advice arise, it is thought that the compliance costs for group D are likely to be marginally less for the new proposal than for the IR35 basis. Clearly these are additional costs over the present baseline, as group D companies, the agencies and their clients have to learn new rules and take advice in the face of any new legislation in their area. But the saving from dropping the registration scheme and the unfamiliar control test are scored as reducing the additional costs at the upper end of the range (£1.5m to £8m in place of £1.5m to £9m).

Assumed response to the new rules

31. Clearly there is more scope for non-tax considerations to affect the decision of what business form to take when there is little difference in the tax and related compliance costs between options. The effects of this uncertainty are modelled by assuming three different representative scenarios for broad levels of continuation of personal service companies under the new rules:
- i) 25% of service companies in Table 2 continue;
 - ii) 50% of service companies in Table 2 continue;
 - iii) 75% of service companies in Table 2 continue.

Compliance costs for a typical service company

32. The current costs (before the IR35 announcement) of the intermediaries are the baseline compliance costs, as they are the response of the industry in complying with the relevant legislation, on the assumption that that structure is adopted to secure tax/NICs savings. The costs of operating the service company might consist of:
- one-off costs of setting up an “off-the-peg” service company of around £300;

- ongoing minimum costs of around £200-£300 a year. This would include company formation and the cost of basic advice from an agency specialising in these arrangements;
- where the arrangements require more advice, then the accountancy costs are higher. The minimum is thought of as applying to Group C, and higher costs typically arise for Groups A and B.

Current compliance costs

33. The current costs of setting up and operating a service company are shown below in Table 2 for the estimate of between 33,000 and 66,000 companies that are caught under the new proposals. The costs are a mixture of start-up and ongoing costs, as discussed in the following paragraphs. These existing costs are estimated on the basis of “bottom up” assumptions about payroll, accountancy and legal costs of contracts in each group. In forming these estimates the Revenue has drawn upon various pieces of information from outside bodies and external survey information.⁴ This is shown as separate columns of unit cost in a range of lower and upper values in Table 2. It is difficult to be precise because of the wide range of situations covered and duration of contracts within the service companies. In the following tables the start-up costs tend to re-occur, depending on contracts, and so the annualised equivalents are used as recurrent costs. Thus costs are given as annual compliance costs. The final step is to associate the upper and lower ranges of the number of existing companies with the upper and lower unit costs to derive an implied cost for the recurrent costs pre IR35.

Table 2: Summary of current costs of operating a service company

Group	Number of service companies		Existing unit costs (£ per company)		Existing total costs	
	Lower	Upper	Lower	Upper	Lower	Upper
A	3,000	6,000	1,250	3,000	3,750,000	18,000,000
B	15,000	30,000	300	600	4,500,000	18,000,000
C	15,000	30,000	200	300	3,000,000	9,000,000
TOTAL	33,000	66,000			11,250,000	45,000,000

34. Annex Table 1 shows the costs of complying with the IR35 proposal, following the same pattern as Table 2. It is thought that the effect of this proposal would have been that these individuals currently operating through a service company would become direct employees. Here the compliance costs fall on the clients in A, B and C, together with the wider impacts on Group D. There are no compliance

⁴ For example the Professional Contractors Group (PCG) survey as described in their press notice of 21 May 1999 was used to confirm estimates of costs in the service companies.

costs left in the service companies as these are assumed to be wound up. This table, which appeared in the Regulatory Impact Assessment published in May 1999, is included for illustration only, as there is no intention to legislate on this basis. Prof Burton⁵, using a different methodology, has estimated a recurrent compliance cost of £58 to 115 million per year above the current level, based on the PCG survey.

35. It can be seen from Annex Table 2 that under the proposal, if the worker chooses to continue to operate through an intermediary, the assumed unit costs, compared to the existing basis in Table 2, are:
- left unchanged for the top of the range for group A, but increased by £100 for Group B (from £600 to £700); and increased by £50 for Group C (from £300 to £350);
 - costs for clients are the same as now, where the worker continues to work through a service company - but greater if clients take the worker on as an employee. Under the IR 35 proposal clients would have faced higher compliance costs in either case because of the registration scheme rules;
 - left unchanged at the bottom of the range for group A and C but increased by £50 for group B (from £300 to £350).
 - There is also an additional compliance cost of up to £8 million imposed on the wider range of companies in group D – less than under IR35 (up £ 9 million) because they are assumed to find the D/E test easier to apply than the unknown control test.

Compliance costs of options

36. There is uncertainty as to how many service companies will choose to accept the greater flexibility of retaining the service company structure. At one extreme all affected service companies could choose to close by preferring to go into direct employment, at the other extreme all the affected service companies could continue. We expect the outcome to be somewhere in a central area between those two extremes.
37. We expect that between 25% and 75% of the service companies will choose to continue. Thus the compliance costs of three representative scenarios: 25%, 50% and 75% of service companies continuing under the proposals are set out here. The final step is to present the compliance cost of the new proposal under the three scenarios as the change in compliance costs against the existing position. This is set out in Table 3. The three scenarios of the new proposal describe the range of the additional compliance costs due to the proposal.

Table 3: Compliance costs of the three scenarios (£ Million)

Regime	compliance costs	compliance costs
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⁵ Inflexible Friend, Adam Smith Institute, 1999, p35, one-off costs of £188 million, based on the PCG survey. As this survey was based on respondents who wrote in, rather than being randomly selected, some of the results are likely to be biased.

	-lower £ million	- upper £ million
Scenario		
25% continue	-1.2	3.0
50% continue	-0.1	6.0
75% continue	1.0	9.3

Discussion of Table 3

38. The above figures are indicative of the broad levels of the recurrent compliance costs of the options. The 25%, 50% and 75% scenarios are derived by pro-rating across Groups A, B and C with the same factor. While it is quite possible that a 75% overall mix could be obtained by a less than 75% proportion in group C existing with a more than 75% proportion in Group A, this would probably only marginally affect the numbers. Note that in the first year of operation of the new proposal there will be some additional one-off costs of transition, but in the following years the recurrent costs would be expected to be as given in Table 3. The one-off costs total some £15 to £20 million, with derivation as shown in the Annex,
39. Thus the new proposal under the three scenarios is compared with the current compliance costs. At the lower end the **additional annual compliance cost is broadly speaking negligible**, though in the 75% scenario it would be about £1 million. At the upper end the additional compliance costs are **some £3, £6 or £9 million per year for the three scenarios (25%, 50%, 75%), respectively**.

Consultation with small business: “The Litmus Test”

40. The change in the proposals results from consultations with business representatives during the summer. Discussions continue, in order to ensure that the proposals are easy to understand and apply.
41. The main features are set out in the example, which is set out in the following table. The overall average tax and NIC yield of the proposal is equivalent to approximately £6,000 per service company. That is the tax/NIC yield from the average mix of Groups A, B and C of some £300 million (steady-state) averaged across some 50,000 companies.

Worked example - typical compliance costs and benefits

42. The worked example is based on the compliance costs and benefits of a Group B service company which is broadly speaking both the representative small company for the litmus test and the most typical example of an affected service company. This example also covers the compliance costs of the clients and the agencies⁶

⁶ In some industries it is common for a client to contract with an agency, which in turn contracts with the service company for the supply of the worker’s services. Agencies would receive gross payment from the client. They are broadly unaffected by the new proposals, though would have been seriously affected by IR35. See also DTI (1999) condoc on regulation of the private recruitment industry employment agencies for other background material.

Example of combined client and small business compliance costs in Group B

	<u>BENEFITS</u>	<u>COSTS</u>
<u>Current (Pre IR 35)</u>		
<u>Service company</u>		
	Receives gross on invoices in excess of around £50,000 to £60,000 per year.	Agency costs plus Accountants costs for setting up corporate status, preparing accounts, paying dividends and paying any directors fees and/or wages in the company.
		Combined agency and accountant package Minimum £200 to £300 for ongoing annual costs. Minimum £200 to £300 for setup costs in year 1
Client	Pays gross, no payroll, PAYE or other employment problems. Avoids employer NICs	Only short term hold on the person providing services.
		Minimal compliance cost for payment of say 12 invoices per year.
Total combined compliance costs		First year £600 to £800 Subsequently £300 to £600
IR 35 Budget		
<u>Service company</u>		Reviews existing contract Checks for registration
		Service company and client jointly recognise that the control test catches them in either a registered or un-registered company. Payment of net in PAYE/NICs plus possible double tax charge on the dividend. Cost of operating service company as above.
		Decides incentives favour direct employment – end of corporate structure
	Worker gains NIC contribution and other employment benefits.	No compliance cost (client picks up compliance costs)

IR35 (cont'd)		
Client		Reviews existing contract Checks for registration
	More established hold on the person as an employee	Jointly decide for direct employment. Faces costs of Reviewing each individual case, writing to terminate contract. Putting into PAYE as joiner + ongoing costs through year One off costs £150 to £300 Say equivalent of £150 to £500 per year
		Loses some flexibility. Some pressure on wage costs, probably in cost of employer NICs.
Total combined compliance costs		Recurrent cost £150 to £500 on average per year assuming 2 to 3 years in post to recoup one-off.
Other costs on Group D		Some compliance costs affect other personal service companies just outside the group B frontier – learning the rules and/or establishing that they are not in “B”
		Some probably small compliance costs for clients of above Group D affected by the frontier eg costs of seeking opinion of whether relevant contract exists.
New Proposal	Clients and agents in Group B generally avoid the compliance costs	Group B service companies take on the compliance costs as part of the business.
	Clients pay gross to service companies, no payroll, PAYE or other employment problems.	Increase in overall compliance costs depends on scenario.
	Flexibility to keep service company	On average the compliance costs of a continuing service company B would rise by between £50 and £100/year
	Overall some £300 million of annual tax/NIC revenue	Post tax/NICs personal incomes fall except where

	is raised from countering avoidance. Restores fairness to those competing against the tax avoiders.	market conditions allow some price increases when companies seek to recoup part of the tax loss.
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Effects on International Competitiveness

43. As a result of the anti-avoidance measures on the above companies, but only those companies, individual workers who are generally the directors of service companies will in future be paying tax/NICs on a fair basis. We would expect, other things being equal, to see such affected personal service companies attempt to raise prices where market conditions permit – rather than suffer a loss of post tax income. To the extent that prices increase for services in the UK there will be some loss of international competitiveness. However, other international tax authorities will, no doubt, carefully study the UK measures.

Other costs, including enforcement, monitoring and review

44. The Inland Revenue will incur costs in monitoring, reviewing and enforcing the new legislation. These will include the costs of :

- i) supplementing the existing guidance on the employment status tests to reflect the fact that these tests will now apply where an individual is working through an intermediary;
- ii) providing advice about the employment status rules on request. This will be done using the existing network of designated status inspectors and the existing Employers’ Helpline. It is assumed there will an increase in the number of enquiries about the employment status tests because the population that needs to consider these tests will increase under the new legislation. This will be managed, in part, by the fact that the number of designated status inspectors in the field was effectively doubled when the Inland Revenue and Contributions Agency merged earlier in 1999;
- iii) developing a voluntary compliance strategy to assist affected taxpayers;
- iv) policing compliance with the application of the new legislation at the service company level; and
- v) devising strategies for the cost effective targeting of compliance resources, as now.

45. Under the amended proposals, the Inland Revenue will not incur the additional costs of setting up, maintaining and policing compliance with the new registration scheme proposed under IR35. Nor will it incur the costs of having to train its nominated status inspectors in the application of the new ‘control test’ proposed under IR35. Nominated status inspectors will instead apply the existing employment status tests with which they, the accountancy profession and the wider business community are already familiar

46. The extent of the work required by the Revenue depends on the number of service companies that continue to operate. The assumption in IR35 was that the individuals involved in some 50,000 service companies would move into

conventional employment. It was assumed that this would have generated processing and compliance savings because of the reduction in the number of service company accounts to be dealt with. Under the modified proposal it is more realistic to assume that a significant number of service companies will continue to operate. This means that the processing and compliance savings anticipated under IR35 will not be achieved.

47. The Inland Revenue will monitor compliance with the new legislation through its established programme of compliance surveys. The additional public service costs associated with the measure are £175,000 in 1999/2000 (set up costs), £500,000 in 2000/01, £210,000 in 2001/2 and £55,000 a year thereafter. These costs include: giving advice to businesses and their advisers; clerical and technical support on the application of the tests; the publication of additional guidance; and general record keeping.

Summary and recommendations

48. These changes will:

- protect the National Insurance fund from loss of revenue;
- restore fairness in the workplace by ensuring that those who use intermediaries do not enjoy a fiscal advantage over direct employees;
- restore the protection of employment law to workers who transfer to direct employment as a result of the new rules; and
- strengthen the Government's drive to encourage business by enabling it to target incentives at genuine enterprise.

49. At the lower end of the estimated range of costs the **additional compliance cost is broadly speaking negligible**, though if 75% of workers choose to continue to operate through service companies, it would be about £1 million. At the upper end the additional annual compliance costs are **some £3, £6 or £9 million higher for the three scenarios (25%, 50%, 75%), respectively**. In addition there is likely to be a one-off cost of some £15 to £20 million (covering the three scenarios) in the first year. As an anti-avoidance package, these compliance costs are not excessive; further part of these costs could be seen as a reflection of the service companies choosing, within a tax/NICs neutral framework, to continue in the corporate form, which brings some attendant costs.

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Annex Table 1: Estimated unit recurrent costs of complying if ALL workers affected revert to direct employment

Group	Number of service companies		Unit cost of taking into direct employment (£ per company/yr)	
	Lower	Upper	Lower	Upper
A	3,000	6,000	1,500	4,000
B	15,000	30,000	150	500
C	15,000	30,000	40	80
D	N/A	N/A	N/A	N/A
TOTAL	33,000	66,000		

- Annex Table 1 follows the same pattern as those for the current legislation in Table 2, and shows the unit recurrent costs of taking everyone into direct employment. In Group D the unit costs are not meaningful, but the total cost is estimated to be some £1.5 to £9 million. Annex Table 2 shows the unit costs of complying with the proposed legislation in the groups *on the assumption that all the existing service companies remain as service companies*. Group D has total costs of some £1.5 to £8 million. These tables are included for presentational reasons to compare the unit costs of the options.

Annex Table 2: Estimated unit recurrent costs if service companies continue

Group	Number of service companies		Unit cost of running service cos (£ per company/yr)	
	Lower	Upper	Lower	Upper
A	3,000	6,000	1,250	3,000
B	15,000	30,000	350	700
C	15,000	30,000	200	350
D	N/A	N/A	N/A	N/A
TOTAL	33,000	66,000		

The one-off costs of complying with the new proposal

2. The one-off costs of complying with the new proposal are considered below. In the first year most people in Groups A to D will need to spend time in learning the rules and consulting with advisers over the effects, and possibly altering the terms of their contracts. In some cases this will involve contacts and negotiations with the Revenue, and for example where applicable the costs of successfully appealing against Revenue decisions on status, in which case such costs would fall into Group D. An estimate of the cost of this work for the first year is given below; it is assumed that after the end of the first year there are no further material one-off costs. In round terms some £15 to £20 million is estimated for the total one-off costs.

3. The one-off costs depend on how many service companies choose to continue, that is which of the three scenarios apply. In outline, some 6,000 companies of the Group A could on average take up a £1,000 of accountants' work and a further 500 related clients might spend a similar amount. Some 10,000 to 25,000 Group B companies might spend £400. At the Group C end some 10,000 to 20,000 might incur £50 of extra cost. In Group D there could be further expenditures by a number of service companies who are just outside the frontier, some of whom as a result of status cases are deemed not to be affected. There are also the wider learning costs of the legislation for employers, agents and for professionals; within Group D some £3 to £4 million is estimated. In round terms the total one-off cost is estimated to be between £15 and £20 million across the scenarios.

Regulatory Quality Certificate

Declaration:

I have read the Regulatory Impact Assessment and I am satisfied that the balance between cost and benefit is the right one in the circumstances.

Signed by the responsible Minister.....

Date.....