

TAX AND THE LABOUR MARKET: TAXING PERSONAL SERVICES INCOME IN THE UK

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ABSTRACT

In March 1999, the UK Inland Revenue (now Her Majesty's Revenue & Customs) issued a press release (IR35) announcing changes designed to counter perceived tax avoidance through the use of intermediaries to disguise employment relationships. This paper examines the implementation of these changes, demonstrating that resistance to a proposed fiscal measure can influence the way in which it is eventually enacted. Reference is made to the *Welfare Reform and Pension Bill: Regulatory Impact Assessment* (1999), the Professional Contractors Group, and *The Queen & Commissioners of Inland Revenue ex parte (1) Professional Contractors Group Ltd (2) Ruud van Zundert (3) Square Mile Projects Ltd*.

I. INTRODUCTION

On 9 March 1999, the UK Inland Revenue (as it then was)¹ issued a press release, numbered IR35, announcing somewhat inchoate changes designed to counter perceived tax avoidance through the use of intermediaries to disguise employment relationships. In IR35, the Chancellor's 1999 budget announcement of changes designed to counter avoidance 'in the area of personal service provision' was amplified, and the Inland Revenue's intention to consult with interested parties with respect to the practical application of new legislation was articulated. It was announced that the new legislation would take effect from April 2000.² The press release was followed in April 1999 by a more detailed explanation of how the scheme would operate; this met with vociferous opposition, particularly from the Professional Contractors Group (PCG).

The stated aim of the proposed changes was 'to ensure that people working in what is, in effect, disguised employment will, in practice, pay the same tax and national insurance as someone employed directly'.³ It was announced that there was no intention to interfere with the existing boundary between employment and self-employment, and further that a 'primary concern is to minimise any impact of [the] changes on ordinary business not involved in avoidance'.⁴

Part of the motivation for the changes, it seems, was to ensure that measures in support of small and medium-sized companies were properly targeted at 'genuine entrepreneurial activity'.⁵ The government estimated that the number of service companies whose engagements have the characteristics of employment had increased from between 20 000 and 50 000 to between 33 000 and 60 000 in the years immediately preceding the announcement.⁶

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1 In 2004, Inland Revenue was merged with Her Majesty's Customs and Excise to form a single revenue authority, Her Majesty's Revenue and Customs (HMRC). References in this paper are to the Inland Revenue since the events discussed pre-date the merger.

2 The fiscal year in the UK for income tax runs from 6 April to 5 April in the following year.

3 Inland Revenue, 'IR35' (Press Release, 9 March 1999) HM Revenue & Customs <<http://www.hmrc.gov.uk/ir35/ir35.htm>> at 5 January 2009.

4 Ibid.

5 Ibid.

6 Inland Revenue, *Welfare Reform and Pension Bill: Regulatory Impact Assessment — National Insurance: Service Provision through Intermediaries*, RIA 1999 (Revised October 1999) HM Revenue & Customs, 4 <<http://www.hmrc.gov.uk/ir35/ria.htm>> at 5 January 2009.

Considerable debate ensued and, on 23 September 1999, a diluted version of the scheme was published. Even in its final form, however, the changes, which are universally referred to as the IR35 rules, had a significant impact on the contracting community, and there were predictions of wholesale emigration of contractors to more sympathetic tax jurisdictions. As in Australia, the attack was focused on the creation of personal service companies with a view to sidestepping PAYE income tax and other employment-related obligations, as well as taking advantage of differences between the corporate tax rate and individual income tax rates.⁷

The use of personal service companies in the UK to avoid employment-related tax obligations was by no means a new issue. Indeed, the Finance Bill 1981 (UK) contained provisions described by Inland Revenue as being introduced to ensure that agency workers were taxed as employees even if they operated through a company. In April 1982, however, the then Financial Secretary announced that the government had decided not to proceed with the legislation.

The IR35 rules have been altered since September 1999 and additional measures put in place to combat the alienation of personal service income. However, this paper is a historical snapshot of the implementation and its immediate consequences. This paper demonstrates that resistance by affected parties to a proposed fiscal measure, in this case an anti-avoidance regime targeting contractors, can have an influence on the way in which the regime is eventually implemented. To this end, the paper examines the immediate reaction by those affected and the associated coverage by the media, and explores the issues raised in a legal challenge to the IR35 legislation by the PCG. The challenge was heard in the UK High Court and a decision handed down on 2 April 2001.

II. BACKGROUND TO THE UK TAX SYSTEM

To put the UK position into perspective, it is pertinent to canvass briefly the system of taxation in the UK and the relevant tax and national insurance provisions. In the UK, the non-elected upper house has virtually no power over taxing bills. The voting system is non-compulsory and first past the post. The Chancellor of the Exchequer is the finance minister responsible for introducing tax bills, and the responsibility for policy is more diffuse than in the Australian environment. There is little public discussion of tax policy and while tax compliance work is performed by accounting professionals, as it is in Australia, there is no registration requirement for tax return preparers in the UK. Changes to the tax system are piecemeal which means that individual measures are generally more visible, allowing for more strident opposition from lobby groups. Arguably, however, the general level of interest in tax policy is lower in the UK than in Australia, in part because many taxpayers, whose tax liabilities are dealt with through withholding, are not exposed to the income tax system through the annual ritual of tax return lodgement.

The UK operates a schedular system of income tax and has ostensibly a separate corporation tax, albeit contained within the same code⁸ and operating by largely similar rules. The income tax rules differ for employees and the self-employed, taxed under schedules E and D respectively⁹. Differences arise in terms of income recognition as well

7 The Australian legislation was introduced in a package of three statutes: *New Business Tax System (Alienation of Personal Services Income) Act 2000* (Cth); *New Business Tax System (Alienated Personal Services Income) Tax Imposition Act (No 1) 2000* (Cth); *New Business Tax System (Alienated Personal Services Income) Tax Imposition Act (No 2) 2000* (Cth).

8 *Income and Corporation Taxes Act 1988* (UK) together with Finance Acts each year by which changes are promulgated.

9 Subsequent to the events described in this paper, the Inland Revenue's Tax Law Rewrite Project has produced new legislation governing income tax, and the rules relating to employment income formerly dealt with under Schedule E are now contained in the *Income Tax (Earnings and Pensions) Act 2003* (UK); the rules relating to business income or trading profits formerly dealt with under Schedule D are now contained in the *Income Tax (Trading and Other Income) Act 2005* (UK).

as expense deductibility. For companies carrying on business, the Schedule D rules apply for profit computation purposes¹⁰.

Rates of tax for 2001-02 were as follows:

Income Tax

Taxable Income (£)	Marginal Rate
0 – 4535*	nil
4536 – 6415	10%
6416 – 33 395	22%**
over 33 935	40%***

* This is referred to in the UK as the personal allowance rather than a zero-rate band; the effect is, of course, the same.

** This rate is referred to as the basic rate. A special rate of 20% applied to certain savings income and capital gains falling below the higher rate band.

*** This is referred to as the higher rate.

Corporation Tax

Taxable Profits (£)	Rate Applicable to All Profits
0 – 10 000	10%
10 001 – 50 000	between 10% and 20% on a sliding scale
50 001 – 300 000	20%
300 001 – 1 500 000	between 20% and 30% on a sliding scale
over 1 500 000	30%.

In addition to income tax differences, the UK operates a superficially hypothecated national insurance system which funds unemployment benefits and state age pensions. The national insurance contribution (NIC) scheme requires contributions from the self-employed on a much lower level than those required from employees for whom two levels of contributions apply, from the employees themselves and from the employer.

The basic rates for national insurance contribution purposes for the same year were:

National Insurance Contributions

Employees	10% on weekly earnings between £87 and £575
Employer contribution	11.9% on earnings above £87 per week
Self-employed	7% on annual profits between £4535 and £29 900 Plus £2 per week.

The fiscal advantages can clearly be seen by reference to these tax and national insurance rates. In addition to the technical differences between taxable income determination for employees and self-employed, the rates of tax applicable to individual taxpayers and companies are significantly different, as are the rates of national insurance contribution for employees and the self-employed. Dividends from companies are not subjected to NIC and are taxed concessionally under a partial dividend imputation scheme.¹¹

The advantages of using personal service companies were outlined by Burton J as follows in the *The Queen & Commissioners of Inland Revenue ex parte (1) Professional Contractors Group Ltd (2) Ruud van Zundert (3) Square Mile Projects Ltd* (the 'PCG case'),¹² partly by reference to the affidavit filed by the Chairman of the PCG.

The fiscal advantages were outlined as:

- a. flexibility and timing of exposure to income tax and national insurance contributions (if at all);

¹⁰ To date, the corporation tax legislation has not been fully rewritten and retains the schedular nomenclature.

¹¹ In the UK, the dividend imputation system provides for an automatic credit of 10% of the gross value of a dividend in the hands of an individual shareholder recipient.

¹² *The Queen & Commissioners of Inland Revenue ex parte (1) Professional Contractors Group Ltd (2) Ruud van Zundert (3) Square Mile Projects Ltd* [2001] EWHC Admin 236 (Burton J) (the 'PCG case').

- b. greater range of expenses available for deduction in computing taxable income;
- c. income splitting with spouse/partner; and
- d. retention of profits within the company at low rates of tax.

Commercial advantages were:

- a. limited liability;
- b. clients want to avoid employment-related disputes;
- c. 'company supplies a suitable vehicle for the development of additional business interests and protection of intellectual property rights';
- d. the contractor assumes a greater risk and therefore can charge 'premium' rates for his services;
- e. the client is protected from disputes over employer tax obligations;
- f. contractors can 'use their equity to raise investment capital';
- g. allows family members to have a direct interest coupled with limited liability;
- h. 'director status' i.e. gives contractor control, status and prestige; and
- i. it represents the industry norm, particularly within the information technology (IT) industry.¹³

In terms of the scale of avoidance, the National Audit Office estimated in 1981 that the operation of 30 000 service companies resulted in a loss of revenue of about £40 million. By 2000-01, there were estimated to be between 90 000 and 120 000 companies with a revenue loss of some £350 million.¹⁴

III. THE FIRST ARTICULATION OF A POSSIBLE APPROACH

In relation to the perceived tax avoidance associated with personal services income, the government reportedly considered five options as follows:

1. Retain the status quo. This was viewed as perpetuating the inequity whereby those who didn't organise their affairs efficiently paid more tax;
2. Implement a general anti-avoidance rule, previously considered but rejected in the UK;
3. Impose NICs in respect of dividends. This was rejected on the basis that it would be too difficult to distinguish dividends that originate from 'genuine enterprise and investment';
4. Outlaw personal service intermediaries. It was felt that this would 'unnecessarily constrain the operation of the labour market and might discourage genuine enterprise'; and
5. Follow the recommended course; that is, identify the target categories of personal service intermediaries and ensure that appropriate PAYE and NICs are collected.¹⁵

In April 1999, a document entitled *Proposed New Rules on the Provision of Personal Services: Summary of a Possible Approach* was promulgated by the Inland Revenue as a basis for discussion, headed with the notation that it was not a consultation document.¹⁶ It was proposed that the new rules would apply where a worker performs services for a client under the supervision or control of the client and the services are provided under a contract between the client and an intermediary. The new rules would not apply where the services were provided as a part of an arrangement for the supply of materials and/or equipment, where the client is an individual, or where a specific exemption applied. Under this approach, client firms would be responsible for determining whether the arrangement constituted disguised employment. A certification scheme would allow potential clients to

¹³ Ibid [3].

¹⁴ Ibid [18].

¹⁵ Inland Revenue, above n 6, 4.

¹⁶ Inland Revenue, *Proposed New Rules on the Provision of Personal Services: Summary of a Possible Approach* (1999) HM Revenue & Customs <<http://www.hmrc.gov.uk/ir35/origsum.htm>> at 5 January 2009.

determine whether the arrangement was one to which the new rules applied.¹⁷ The benefits of this recommended course of action were stated by the government as being to allow the use of personal service companies if that were the industry norm, and to make the choice of using an intermediary broadly tax neutral. It was noted that encouraging workers to return to employment would allow them to gain the benefit of employment protection legislation.¹⁸ In this respect, the government was effectively signalling benevolence; acting in the best interests of misguided taxpayers.

The effect of the new rules would be to deem the worker to be an employee of the client, with attendant income tax and national insurance contribution obligations attaching to the client. Different consequences would then flow depending on whether the intermediary was incorporated, a partnership or an individual for tax purposes. The intention was that the client would be held responsible in the event of default, in the absence of appropriate certification testifying to exemption.

From April 1999, the Inland Revenue distributed information packs and sought feedback from the public. By the end of August 1999, they had sent out 1800 copies of the information pack and held two meetings with 38 representative bodies. Over 1700 written comments and suggestion were received.¹⁹

A. Responses to the Original Proposals

The original proposals were not well received and a flurry of vociferous opposition to the measures ensued. Apart from overall concerns about attacking this particular sector of the economy, a number of specific aspects of the proposals were heavily criticised. In particular, the certification scheme was 'denounced as being bureaucratic and burdensome'²⁰ and there was considerable concern that the crude control test would operate to bring people within the net who would otherwise have been classified as self-employed were it not for the intermediary. There were significant fears that the UK economy would be damaged by a collapse of the contracting market and by economic migration to more benevolent tax regimes such as the Netherlands.²¹

It is not possible to canvass all the various responses to the measures. However, what follows is a selection to provide an indication of the mood, starting with the debate in the House of Lords. The discussion there reflects what was being said in the wider community.

1. The House of Lords

During the passage of the Welfare Reform and Pensions Bill 1999 (UK), which contained in clause 70 the regulations relating to national insurance contributions,²² the House of Lords was critical of the manner in which the government had put the matter forward. During the committee stage debate of 20 July 1999, Lord Higgins (Conservative)²³ expressed the view that the NIC regulations should be contained within the Finance Bill and noted that the House of Commons had been unable to consider a full regulatory impact assessment (RIA) before the Bill left there. He was of the view that the consultation to date had been inadequate and that the relevant clauses were rushed through at the last minute.²⁴

17 Ibid.

18 Inland Revenue, above n 6, 5. The reference to employment protection legislation is to entitlements such as annual and other forms of leave and statutory redundancy pay.

19 Inland Revenue <<http://www.ir.gov.uk>> at 5 July 2001. Copy held by author.

20 Anne Redston, 'The Good the Bad and the Indifferent' (1999) 143 *Taxation* 667.

21 Ibid.

22 The national insurance contributions legislation is dealt with under a separate Bill from the PAYE provisions which are contained within the Finance Bill 2000.

23 All the peers mentioned in this passage are (or were) life peers, who represent the interests of a political party. At the time, the Queen formally appointed life peers on the advice and recommendation of the Prime Minister: United Kingdom Parliament, *Different Types of Lords* <http://www.parliament.uk/about/how/members/lords_types.cfm> at 5 January 2009. The legislation in question was an initiative of the incumbent Labour party.

24 United Kingdom, *Parliamentary Debates*, House of Lords, 20 July 1999, column 910 (Lord Higgins).

Lord Jenkin of Roding (Conservative) was anxious about the use of the control test as outlined in the Bill.²⁵ Noting that the policy of the present and previous governments had been to promote creation of business, he said 'I find the clause totally misconceived'. He expressed concern that the method chosen by the government would be to capture large numbers of individuals who, not engaged in tax avoidance, are 'conducting their affairs in a thoroughly efficient, commercial and effective way in a modern, flexible economy.'²⁶ Lord Grabiner (Labour) replied that the client is often the main beneficiary of the arrangements in being relieved of employment-related obligations, and that the arrangements are effectively forced on employees, particularly in the IT industry. 'The real problem is not the Government's objective, but their proposed method. As it stands, Clause 70 will add to the complexity and uncertainty of the law because it gives power to the Treasury to decide who is ... to be treated as an employee ...'²⁷

Lord Campbell of Croy (Conservative) was of the view that 'if it goes through in its present form, I believe this proposal would have a devastating effect on small firms and an upsetting upheaval for the present framework and organisation of IT consultancies.'²⁸ In response to Lord Higgins's accusation that the government was attempting to avoid debate, Lord McIntosh of Haringey (Labour) pointed out that the Chancellor's budget announcement was made 'when Committee stage was halfway through. The provision was introduced in report in May ... There was not a great deal of delay, and certainly we did not avoid debate in this House'.²⁹ He went on to say that inclusion of the relevant provision in the Finance Bill would have precluded debate in the Lords. There is also a convention that Finance Bills are concerned with revenue which goes into the Consolidated Fund, including income tax, and the clause under consideration relates to the National Insurance Fund, and, therefore, does not belong in the Finance Bill.

Lord Higgins expressed concern that under subclause 70(9), any modification to the income tax rules which need to flow through to national insurance for the purposes of consistency may, with concurrence of the Secretary of State by order, be made by Treasury. Therefore, it may be possible for the next Finance Bill to alter the clauses in the Bill under consideration. In response, Lord McIntosh of Haringey stated that the Treasury does not only deal with Finance Bills,³⁰ a comment which, however, failed to address Lord Higgins's concerns. Lord McIntosh of Haringey explained the purpose of the control test was, in part, to simplify the case law dealing with the Schedule E and Schedule D divide, and also to put the responsibility on the client for status determination. He acknowledged that this issue was an important one in the ongoing consultation, as was the voluntary certification system.³¹ He went on to say that 'we shall not retreat from the position that the intervening service company is an abuse of tax and national insurance legislation'.³² When challenged that not all personal service companies are to be banned, he admitted that many genuine cases exist and only those set up to avoid tax were being targeted. Lord Higgins welcomed the promise of extensive consultation, stating that 'we have been inundated with representations from interested parties.'³³ In relation to the regulatory impact assessment, Lord Higgins was critical of its narrow focus on individual companies and noted that there are much wider impacts of the legislation than at the individual company level. He pressed the point that clause 70 as drafted may well adversely affect genuine legitimate service companies.

A number of amendments were proposed in relation to the control test and the certification scheme, to which Lord McIntosh of Haringey responded that these issues

25 Ibid column 912-3 (Lord Jenkin of Roding).

26 Ibid column 914.

27 Ibid column 915 (Lord Grabiner).

28 Ibid column 917 (Lord Campbell of Croy).

29 Ibid column 921 (Lord McIntosh of Haringey).

30 Ibid.

31 Ibid column 922.

32 Ibid column 923.

33 Ibid column 923 (Lord Higgins).

were under review as part of the consultation process and reassured the House that the government was seriously concerned to ‘minimise burdens on business.’³⁴ In response to an amendment proposed to give special consideration to the IT industry, which was largely project-driven and required flexibility in service provision, Lord McIntosh of Haringey cautioned that some representations from that sector may have been overstated.³⁵

2. *The Chartered Institute of Taxation*

The Chartered Institute of Taxation made representations to the Paymaster General on 3 August 1999 in the following terms:

In our representations on the Government’s proposals for personal service companies, we emphasised that full consultation was vital. Those of us who met you on 14 July made the same point then. We are writing now to say this again, in light of remarks made by Lord McIntosh of Haringey in the course of the House of Lords Committee Stage Debate on clause 70 of the Welfare Reform and Pensions Bill (Hansard, 20 July 1999 columns 912 to 938).

Lord McIntosh of Haringey made it clear that the Government would publish the results of the consultation (column 923). He also stated that the Government would take into account what has been said about the relevance of the existing boundary between employment and self-employment (column 930). Finally, he offered a seminar for peers interested in the subject (column 938).

All of this is most welcome. It betokens a willingness to respond to concerns that the proposals in their original form would not work. Yet while decisions on tax policy objectives rest with the Government, proper consultation on how to achieve these objectives is vital. It ensures that any proposals are workable and serves to scope out and assess any unanticipated problem areas. The comments already received by the Government in this area concern the existing discussion document, and may not cover all the issues raised by a new approach.

We therefore believe that the Government should publish a consultation document followed by two or three months of consultation, as is normal for significant proposed tax changes that are not being introduced overnight.

It may be that the Government already intends to do this. Lord McIntosh of Haringey’s statements would be compatible with that intention. If this is so, we would very much welcome your early reassurance on the point.³⁶

3. *The Adam Smith Institute*

In 1999, the Adam Smith Research Trust published a study by Professor John Burton.³⁷ The study explores the new labour market paradigm, which has emerged over a number of years, in which a central component is ‘the existence of a large contractual fringe of highly qualified professional workers’.³⁸ Professor Burton was critical of IR35 in respect of the consequences for the new, flexible economy, concluding that the outcome is the creation rather of a ‘New Gummed-up Economy’.³⁹

4. *Responses via the Print Media*

As well as articles presenting general comment and analysis criticising the thrust and impact of IR35, there were a number of letters written to newspapers on the same theme. In May 1999, Iain Bruce wrote in *The Scotsman*:

³⁴ Ibid column 930 (Lord McIntosh of Haringey).

³⁵ Ibid column 931.

³⁶ The Chartered Institute of Taxation <<http://www.tax.org.uk/showarticle.pl?id=234&n=379>> at 5 July 2001. Copy held by author.

³⁷ John Burton, *Inflexible Friend: The New Flexible Economy and Professional Services* (1999) Adam Smith Institute <<http://www.adamsmith.org/publications/economy/inflexible-friend-19991126249/>> at 5 January 2009.

³⁸ Ibid 38.

³⁹ Ibid. The reference to the ‘gummed-up economy’ is in response to the Blair government’s rhetoric of fostering a ‘joined-up government’.

Unless Britain's 330,000 IT contractors take radical action within months, Treasury plans to close a tax loophole may cost them more than GBP 450 million a year, leave them locked in a struggle for work and, industry figures predict, deal a devastating blow to the country's computing industry.⁴⁰

In July 1999, David Moore wrote a letter to *The Independent* saying: 'Mr Blair's comments in praise of entrepreneurialism and risk-taking are strangely at odds with his Government's actions as manifest in the 1999 Budgetary proposal known as IR35 ...'⁴¹ In the same month, Sanjay Gupta wrote a letter to the *Financial Times* which included the following:

The government's IR35 proposals are due to take effect from April 2000 and are meant to apply to people like me who provide our services via a limited company. If these plans go through, the government will basically kill the IT contract industry in this country, forcing us into the pay-as-you-earn system.⁴²

Under the headline 'Brain Drain Threat Claim Over Change to Tax Laws', a report in the *Evening News* commented: 'Britain could suffer a major technology brain drain if new tax rules are introduced ... More than half of the UK's IT specialists are likely to quit the country within two years if tax loopholes are closed with the new IR35 law ...'⁴³

IV. THE GOVERNMENT'S RESPONSE TO 'CONSULTATION'

On 23 September 1999, the Inland Revenue issued another press release announcing the new rules, apparently developed following 'extensive consultation'.⁴⁴ Entitled 'Personal Services Provided Through Intermediaries — Preventing Avoidance: Preserving Flexibility', the press release has been misleadingly referred to as the revised IR35. In it the Paymaster General, Dawn Primarolo, was quoted as saying:

Consultation has confirmed that there is a genuine issue of tax avoidance in this area and there is widespread agreement that we are right to tackle it. I am determined that nobody should be able to avoid paying their fair share of tax and NICs just because of the way they structure their relationship with their clients.

But we have always recognised that any action must do no unnecessary damage to the flexible labour markets where intermediaries are currently used.

I have therefore asked the Inland Revenue to publish a number of changes to the proposals they distributed in April 1999. These changes mean that we will still be able to stop this avoidance, from next April, but in a way that is more tightly targeted and does not prevent the use of intermediaries where they provide non-tax advantages.⁴⁵

The revised approach was designed to narrow the scope of the new rules following representations that persons working through intermediaries should not be penalised so long as they are prepared to 'pay the right amount of tax and NICs.' In terms of identifying those to whom the new rules would apply, the existing boundary between employment and self-employment would now be used in preference to the alternative test originally proposed. A major change of focus was the shift of responsibility for ensuring appropriate application of the new rules from the client to the intermediary itself, which then obviated the need for a certification procedure. The press release noted that the new rules would

40 Iain S Bruce, 'The Taxman Cometh', *The Scotsman* (Edinburgh), 18 May 1999, 12

41 David Moore, 'An Unfair Tax', *The Independent* (London), 13 July 1999, 2.

42 Sanjay Gupta, 'IR35: Death Warrant for IT Contracts', *Financial Times* (London), 27 July 1999, 18. See also Carl Hague and John Whiting, 'Why We Must Find Alternative to IR35', *Financial Times* (London), 4 August 1999, 12; 'Slave Issue Revisited: The Revenue Must Soon Explain How it Will Revise the IR35', *Financial Times* (London), 2 September 1999, 25.

43 'Brain Drain Threat Claim Over Change to Tax Laws', *Evening News* (Edinburgh), 21 September 1999, 3.

44 'Extensive' being the Inland Revenue's description, a view not shared by the parties to the consultation.

45 Inland Revenue, 'Personal Services Provided through Intermediaries — Preventing Avoidance: Preserving Flexibility' (Press Release, 23 September 1999) HM Revenue & Customs <<http://www.hmrc.gov.uk/ir35/seprelease.htm>> at 5 January 2009.

yield about £475 million in tax and NICs in the 2000-01 year and £300 million in a full year.

In summary, the new rules were intended to operate so that all money received by an intermediary in respect of a relevant engagement to which the rules apply, net of specified deductions, be treated as having been paid to the worker in the form of salary and wages subject to PAYE and NICs.⁴⁶ Corporate intermediaries would account for PAYE deductions and NICs, as usual, in respect of salary paid to the worker throughout the year, and a reconciliation was then required at the year's end. Any shortfall between actual salary payments and those to which the rules apply would then be deemed to be paid to the worker on the last day of the year, with appropriate remittance required of PAYE and NICs in respect of the deemed payment. Subsequent actual payments to the worker could then be made, free of further PAYE deductions and NICs.

The intermediary, in determining the amount of the year-end deemed payment to the worker, could deduct expenses otherwise deductible under Schedule E, which governs the liability to income tax of employment income and employer pension contributions, plus a further flat five per cent of the gross payment.⁴⁷ In the event that an intermediary failed to deduct and account for PAYE and NICs, the normal penalties for employer default would apply.

In order to clarify the dividing line between employment and self-employment, the Inland Revenue reissued its guidelines, IR56.⁴⁸ In April 2000, the Inland Revenue also released a series of questions in simple language to assist in determining whether a person is employed or self-employed (IR175). A second regulatory impact assessment statement was released in October 1999. The new measures were expected to raise £475 million in 2000-01, £375 million in 2001-02 and £300 million in 2002-03.⁴⁹

A. How the Revised Rules Work

The rules look to whether the worker would have been an employee of the client, which will be obvious in many cases by reference to the terms and conditions of the particular engagement. If a worker is in doubt, Inland Revenue will provide opinions, but only in respect of signed, and not hypothetical, agreements. The interposition of an agency between the client and worker does not alter the question of whether the arrangement would otherwise be employment.

There is an exemption for genuine employees of a personal service company or partnership who are not shareholders or partners. In addition, there is a *de minimus* exemption for small shareholdings. As Anne Redston notes, 'after all, this is a government which has gone on record as supporting employee shareholdings.'⁵⁰

The Inland Revenue has published a number of guidance leaflets and information, including IR175 entitled *Supplying Services Through a Limited Company or Partnership*. This leaflet provides a guide to determine whether the new rules apply and, if so, what to do. First, a series of questions are presented which are designed to determine whether the taxpayer is employed or self-employed, and reference is made to IR56 for further information in this regard. The second section is designed to determine whether the company or partnership qualifies for application of the new rules. Given that it does, a step-by-step procedure is outlined to deal with the end of the tax year. The leaflet

46 The national insurance rules are contained in the *Welfare Reform and Pensions Act 1999* (UK), ss 75-76, as implemented by the *Social Security Contributions (Intermediaries) Regulations 2000* (UK). The income tax rules are contained in the *Finance Act 2000* (UK) s 60 and sch 12.

47 The range of deductions allowed against employment income in the UK is more restricted than in Australia, but shares the same broad attribute of nevertheless being more restricted than those deductible from business profits.

48 Inland Revenue, *Employed or Self-employed? A Guide to Employment Status for Tax and National Insurance Contributions* (IR56). This document included a series of questions to assist in determining whether a person was self-employed or employed. This document has since been updated but includes similar questions: HM Revenue & Customs, *Employed or Self-Employed for Tax and National Insurance contributions* (2008) <<http://www.hmrc.gov.uk/leaflets/es-fs1.pdf>> at 5 January 2009.

49 Inland Revenue <<http://www.ir.gov.uk>> at 5 July 2001.

50 Redston, above n 20, 667.

concludes with some common questions and a worked example. The language in which the leaflet is worded is presumably taxpayer-friendly. However, this results in oversimplification, and it is unclear to whom this guidance is directed. Most taxpayers utilising personal service intermediaries would presumably be using the services of professional advisers, particularly those using the corporate form. It is noted that the leaflet states that the Inland Revenue will give advice on existing contracts only; that is, written opinion as to employment status. One interesting point is the use of the phrase 'he pays himself a salary' in the worked example, referring to the payment by the company to the worker, and disregarding the legal form of the arrangement.

A more detailed information leaflet is IR2003 which specifically deals with how to compute the deemed payment and pay any ensuing liability to tax and NICs. Again, this leaflet uses a step-by-step approach, although it numbers the steps differently to IR175, but expands the narrative to include more examples of allowable and non-allowable expenses.

B. Reaction to the Revised Rules

1. Professional Contractors Group

According to Redston, '[t]he proposals were met by almost unanimous opposition, and were condemned as burdensome, disproportionate and damaging to the economy.'⁵¹ Not surprisingly, the loudest protestations came from the PCG. The PCG was formed in May 1999 specifically 'to provide independent contractors and consultants with a representative voice in opposition to the original IR35 proposals'.⁵² The start-up of the PCG was funded by some 2000 independent contractors, principally from the IT and engineering sector.⁵³ Indeed, it was in deference to the PCG that the dilution of the initial proposals occurred. Even given the backdown on the original measures, there was still continuing concern that IR35 would have a detrimental effect on contractors and that many would be forced to relocate overseas.

2. Contractoruk.co.uk

A number of surveys have been conducted to assess the impact of the new rules.⁵⁴ Over the period from 4-31 March 2000, a survey was conducted via the website contractoruk.co.uk (now contractoruk.com), independently hosted by polit.com. Reportedly, 779 contractors took part in the survey and the results were compared with a similar survey conducted by Contractor UK in December 1999. Most of the respondents were IT contractors (85%), and the majority traded as a limited (private) company (95%). When asked 'What are your intentions following the introduction of IR35 in April 2000?' some 23% stated that they would contract overseas. Only 40% said they would remain a contractor in the UK.

3 Accountingweb.co.uk

A posting on accountingweb.co.uk, on 17 April 2000, called into question Dawn Primarolo's understanding of IR35. She had written to the *Independent* newspaper saying:

The people of this country pay tax and NICs depending on whether they are employed or self-employed. We believe that these rules should apply equally to everyone; it is not fair that it should be possible to avoid them simply by setting up a one-man company.

People who are genuinely self-employed, taking risks and creating employment, have nothing to fear from this legislation. Indeed we can give support to businesses only if we

51 Ibid.

52 Professional Contractors Group, *Background* <http://www.pcg.org.uk/cms/index.php?option=com_content&task=view&id=528&Itemid=280> at 5 January 2009.

53 Shout99, *PCG Judicial Review Briefing* (2000) <<http://www.shout99.com/contractors/showarticle.pl?id=4574>> at 5 January 2009.

54 The methodological validity of these has not been established by the authors. Again, they are presented as an indicator of the public reaction to the changes.

make sure that tax measures designed to encourage enterprise do not go also to people who are really no different from employees.⁵⁵

Nick Parkes of AccountingWEB was critical of the Paymaster General's comments and pointed out that there is nothing offensive about taxpayers seeking to minimise the burden of taxation in the manner in which they arrange their affairs. He stated that it is 'patently unfair to single out a particular group and to remove them from the benefits of incorporation if those benefits are not, at the same time, removed from all small businesses that operate as companies.'⁵⁶ Anticipating difficulties in determining the employed/self-employed divide, he advocated a full backdown with the aim of finding a simpler and fairer approach.

4 *Institute of Chartered Accountants in England and Wales*

The Institute of Chartered Accountants in England and Wales (ICAEW) issued a publication entitled *Towards a Better Tax System*⁵⁷ in which it analysed the IR35 legislation against previously determined attributes of a good tax system. On the whole, the report was not flattering; the overall 'score' awarded to the legislation was 30%, derived from individual scores out of 10 for each of the 10 'tenets' of taxation. The individual scores for each of the tenets are listed and explained here.

Tenet one — statutory: tax legislation should be enacted by statute and subject to proper debate (7 out of 10).

Although the rules are contained in primary legislation, there is some concern that, as they deem income to fall under the PAYE regulations, subsequent changes may not be subjected to full parliamentary scrutiny. In addition, the government has not been clear about the real reasons for the legislation.

Tenet two — certain: in virtually all circumstances, the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs (3 out of 10).

The provisions are widely drawn and, consequently, have broad impact, affecting a variety of sectors of the community. In addition, the test for application of the rules may not be consistent with modern working practices. Other specific uncertainties are listed, the conclusion being that in this regard the rules are seriously flawed.

Tenet three — simple: the tax rules should aim to be simple, understandable and clear in their objectives (2 out of 10).

The style of drafting is inconsistent and operates inconsistently depending on the legal form of the intermediary. There is also inconsistency between these rules and the government's measures which encourage employee share ownership. There is also an issue of exclusions; for example, non-resident entertainers and sportsmen are specifically excluded, while those within another deduction scheme, the Construction Industry Scheme (CIS), are not.

Tenet four — easy to collect and calculate: a person's tax liability should be easy to calculate and straightforward to collect (5 out of 10).

In simple cases, collection via PAYE will be simple. There are some problems, however, where apportionment complicates the computations, and there are also timing difficulties, particularly for agencies.

55 Nick Parkes, *Does Dawn Primarolo Understand IR35* (2000) Accounting WEB <<http://www.accountingweb.co.uk/cgi-bin/item.cgi?id=15521&d=526&h=524&f=525>> at 5 January 2009.

56 Ibid.

57 Institute of Chartered Accountants in England and Wales, *Towards a Better Tax System* (Tax Guide 2/00) (2000) <<http://www1.icaew.co.uk/publicassets/00/00/04/43/0000044306.PDF?CFID=1197517&CFTOKEN=836186>> at 5 January 2009.

Tenet five — properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes (5 out of 10).

The uncertainty over who is captured by the new rules, and the failure of the government to clarify the objectives of the legislation, detract from it being properly targeted.

Tenet six — constant: changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules, and this justification should be made public and the underlying policy made clear (1 out of 10).

Here, the ICAEW is particularly critical and is of the view that the rules are totally inconsistent with the government's policy of making incorporation attractive. The impact of the rules on longstanding arrangements is also regrettable.

Tenet seven — subject to proper consultation: other than in exceptional circumstances, the government should allow adequate time for both the drafting of tax legislation and full consultation on it (5 out of 10).

The initial consultation was poor and the RIA issued almost four months late. Underlying policy was not made the subject of discussion.

Tenet eight — regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, it should be repealed (5 out of 10).

Although it is too early to say how the rules will be reviewed, the ICAEW suggests that the provisions should be terminable at a specified time.

Tenet nine — fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions (0 out of 10).

Here the ICAEW is particularly scathing in the assessment. IR35 is viewed as being both unfair and unreasonable. A number of specific issues are raised. However, on a general level, they note that a group of taxpayers are to receive different treatment without clarity as to whom is being targeted and why.

Tenet ten — competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK (0 out of 10).

IR35 is distortional and contrary to the government's policy of encouraging the growth of electronic commerce.

The Inland Revenue published an extract from the letter of response to the ICAEW's criticisms. An element of surprise was expressed in respect of the suggestion that the government had failed to make its policy intention clear. The letter stated that 'the use of service companies to avoid tax and NIC has been well known to the accountancy profession for years'.

5. Institute for Fiscal Studies

In February 2001, the Institute for Fiscal Studies (IFS) published a discussion paper authored by Professor Judith Freedman dealing with the issue of classification of workers.⁵⁸ Although more broadly concerned with the employment/self-employment divide for tax and other purposes, Professor Freedman also addressed the impact of IR35.

⁵⁸ Judith Freedman, *Employed or Self-Employed? Tax Classification of Workers and the Changing Labour Market* (Discussion Paper No 1, Tax Law Review Committee, Institute for Fiscal Studies, 2001).

She questioned the use of current employment-law classifications for tax purposes, noting that they are used for different purposes and that the employment legislation is moving away from the traditional classification methods in recognition of changes to the nature of work.⁵⁹

In the context of IR35, Professor Freedman considered that the wide net cast might have the ‘curious result that the legislation could deter the very entrepreneurs the government seeks to encourage in other contexts.’ She suggested that reform proposals should not unsettle the position for the vast majority of workers for whom classification is not an issue.⁶⁰ There has been an increase in self-employment in the UK, most evident in the 1980s. There are other pressures, apart from the tax system, which promote, and even enforce, self-employment within certain industries, including a general trend to vertical integration as found, for example, in the IT sector.⁶¹ It is not possible, however, to dichotomise contemporary working arrangements into genuine and ‘pseudo’ self-employed; rather, there is now a continuum with ‘no straightforward division between different groupings. Identification of entrepreneurs within the small business sector is particularly problematical, which makes targeting of government incentives difficult’.⁶²

Tax concepts relating to employment status were developed around standard work patterns in the early part of the 20th century, and these remain relevant for a large number of people. However, variations are increasing, including part-time, temporary, home-workers and teleworkers, which push the divide and exacerbate the difficulties surrounding the tax treatment.⁶³

Professor Freedman was critical of IR56, which she stated was unlikely to be of assistance in borderline cases and gave undue emphasis to providing tools and risking money, which may be misleading.⁶⁴ She guardedly praised the Inland Revenue for providing guidance, noting, however, that brevity can reduce its utility, and too much detail reduces accessibility. In Professor Freedman’s view, some middle ground would seem to be in order.⁶⁵

Professor Freedman also expressed concern that taxpayers falling under IR35 are treated for tax and national insurance as if they are employees, yet they gain no employment rights, which may be seen as unfair.⁶⁶ In addition, one of the stated aims of IR35 was to encourage client firms to return to direct employment contracts. With the change in approach placing the onus on the worker to determine status, this will not be achieved. The incentive for clients to insist on contracts for services remains.⁶⁷

Although primarily concerned with the employee/self-employed divide, which is only one part of the IR35 debate, Professor Freedman suggested that wider consultation could have achieved a more focused approach, and that it was regrettable that other alternatives, such as minimum salary distribution requirements for personal service companies had not been properly explored.⁶⁸

6 *Reaction via the Print Media*

The media reported a muted response to the revised rules. Clare Stewart said in *The Times*:

The Government has given ground in its campaign against tax avoidance by personal service companies ... However, the revised IR35 rules ... have received only a qualified

59 Ibid 8.

60 Ibid 10.

61 Ibid 23.

62 Ibid 24.

63 Ibid 34.

64 Ibid 48-9.

65 Ibid 49.

66 Ibid 75.

67 Ibid 102-3.

68 Ibid 105.

welcome because there remains concern that they will increase the burden of tax and red tape on many small businesses.⁶⁹

More openly critical was a report in *The Guardian*:

Strong passions have been aroused. Mike Callen, chair of the British Computer Society's contractor group, last week described the plans as a 'great day for Holland', predicting that UK firms would be better off siting projects in the Netherlands than taking on UK freelancers who had been forced to raise their rates to pay the extra tax.⁷⁰

The article goes on to quote extensively comments from David Ramsden, then director of the PCG, who remarked that 'any claims of consultation by the government are false', and that '[t]hey've replaced the unworkable with the illogical'. In an article titled 'A Taxing Time for Contractors', Danny Bradbury commented that the laws were 'aimed at the "man with a van" workers in the services industry' and were not suited to IT professionals. Citing sources in various professional groups, he said that a different definition of 'worker' should apply to knowledge-based contractors.⁷¹

V. THE PCG LEGAL CHALLENGE

One of the responses to the rules was a legal challenge to the validity of the enacting legislation.⁷² There were three claimants; the PCG, a Dutch national who was resident in the UK and a small contracting company established in the UK. The latter two were chosen as examples of those affected by the legislation. The defendants were the Commissioners of Inland Revenue. The application was for judicial review, seeking declarations of incompatibility of the IR35 legislation with European Community (EC) law and the *Human Rights Act 1998* (UK). The case was heard in the Administrative Court by Burton J and he handed down his decision on 2 April 2001.

In his judgment, Burton J reached eight 'provisional conclusions' as to the facts open to him upon the evidence:

The intent of IR35 is to eliminate the avoidance of tax and NIC on payments made by clients in respect of services provided by those who are in fact equivalent to employees; and it has that effect on the companies to which it applies.

1. Many service contractors will be required to pay more monies and earlier to the Inland Revenue under IR35 than under the previous arrangements.
2. At least two-thirds of service contractors are in the sector referred to in the Amended Relief⁷³
3. Instead of certainty as to the impact of tax and NIC, service contractors as a result of IR35 have uncertainty as to whether IR35 will nor will not apply to a particular engagement.
4. In respect of engagements or contracts sought, or services to be provided, by service contractors, there is or would be competition with companies who would be unaffected by IR35.
5. Companies unaffected by IR35 will have greater flexibility to arrange their tax affairs, to allocate tax between income tax and corporation tax, to defer tax liabilities, and to pay lesser salaries to those providing the services and higher dividends to shareholders, than service contractors.

69 Clare Stewart, 'Taxman Limits His Attack on Personal Service Companies', *The Times* (London), 24 September 1999, Business; see also Clare Stewart, 'Two Cheers for Taxman's Retreat on Consultancies', *The Times* (London), 25 September 1999, Features. Copy held by author.

70 Neil McIntosh, 'Tax Threat to Freelancers', *The Guardian* (London), 30 September 1999, 6.

71 Danny Bradbury, 'A Taxing Time for Contractors', *The Evening Standard* (London), 27 October 1999, 50.

72 The PCG case [2001] EWHC Admin 236.

73 The 'Amended Relief' mentioned here is in relation to the European Community (EC) law argument mounted by the claimants, and particularised the areas of business activity adversely affected by the IR35. The 'Amended Relief' is discussed more fully below in Part VB, 'The EC Law Argument'.

6. Some service contractors may not continue to operate in the United Kingdom as a result of IR35, and some who have intended to come to the United Kingdom to set up or work as service contractors may not now come to the United Kingdom.
7. Factors 5, 6 and/or 7 above may have an effect on trade between Member States.⁷⁴

A. The *Human Rights Act 1998* (UK) Argument

1. Introduction

In November 1998, the UK incorporated the *European Convention on Human Rights* ('ECHR') into domestic law by way of the *Human Rights Act 1998* (UK). The *Human Rights Act* ('the Act') became operational in Scotland in July 1999 and in England on 2 October 1999. Section 3(1) of the Act provides: 'So far as it is possible to do, primary legislation and subordinate legislation must be read and given effect in a way which is compatible with the Convention rights.' Under s 4 of the Act, a court may make a declaration of incompatibility if the court finds a provision in primary or subordinate legislation incompatible with an ECHR right. Such declarations do not alter the legality of primary legislation, but put the government and Parliament on notice that the matter requires consideration. The courts may, however, strike down incompatible subordinate legislation, providing the primary legislation does not prevent the removal of the incompatibility.⁷⁵

2. The Claimants' Argument

Burton J described the claimants' argument under the Act as 'very much a fall-back argument'.⁷⁶ He dealt with it first in his decision because the argument gave rise to two possible outcomes. The first was a freestanding challenge to the IR35 legislation on the basis that it was incompatible with the Act by reference to Article 1 of Protocol 1 of the ECHR. The second was more complex. As already mentioned, in addition to seeking a declaration of incompatibility with the *Human Rights Act 1998* (UK), the claimants were seeking a declaration that the IR35 legislation was incompatible with EC law. If the defendant were to put forward any justification for a contravention of the EC treaty, a relevant consideration was whether such conduct was incompatible with the fundamental rights protected by the European Court, in particular those rights derived from the ECHR.

Article 1 of Protocol 1 of the ECHR deals with the protection of property:

Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to conditions provided for by law and by the general principles of international law.

The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties.

The claimants' case was that the 'right to enjoy the benefit of a shareholding in a service company is a right of property' and thus protected by Article 1.⁷⁷ The claimants argued that the enjoyment of this right of property was interfered with as a result of the IR35 legislation due to two factors. The first was the additional expense resulting from the legislation (for example, the imposition of income tax and NICs on the notional remuneration) and the second was the uncertainty of the impact of the IR35 legislation.

⁷⁴ The PCG case [2001] EWHC Admin 236 [20-36].

⁷⁵ *Human Rights Act 1998* (UK); *Rights Brought Home: The Human Rights Bill*, Cm 3782 (1997).

⁷⁶ The PCG case [2001] EWHC Admin 236 [38].

⁷⁷ *Ibid* [39].

3. *The Expense*

Burton J referred to two European Commission findings brought to his attention by counsel for the claimants, Mr Barling QC. These were *X v France*⁷⁸ and *Svenska Managementgruppen AB v Sweden*⁷⁹. In Burton J's view, neither were helpful to the claimants' case. In both cases, the European Commission rejected the applicants' arguments that the respective taxation provisions about which they were complaining affected their right to property under Article 1. In the PCG case, Burton J considered that, even if IR35 applied to the full amount of the service company's annual earnings, this was not sufficient 'to amount to a *de facto* confiscation of their property, to fundamental interference with their financial position or to an abuse of the United Kingdom's right to levy taxes'.⁸⁰

4. *Uncertainty*

Burton J pointed out that the service contractors were not subject to any new law but simply the law that would affect them if there was no intermediary in the form of the service company.⁸¹ He then turned to the question of whether uncertainty arose from having to examine each engagement separately to determine whether the service contractor was to be treated as an employee or as an independent contractor. In the former, the IR35 legislation would apply; in the latter, it would not. The common law of employment is the law applicable to making a determination of this nature. The central question is whether the service contractor is 'carrying on business on his own account'.⁸²

At this point, Burton J was critical of some of the Inland Revenue documentation, particularly some of the guidance notes for inspectors that suggest an approach not entirely in keeping with judicial decision-making in the area. In this context, his Honour made reference more than once to examples of inflexibility on the part of the Inland Revenue in its approach to determining whether the service contractor was an employee or independent contractor.⁸³ He repeated that all aspects of the relationship between service contractor and client must be considered. Despite 'these and other areas of potential dispute', he did not consider that applying the common law of employment to a service contractor offended against the concept of certainty.⁸⁴

5. *Burton J's Conclusion on the Human Rights Argument*

Having thus dispatched the claimants' arguments regarding expense and uncertainty, Burton J concluded that there was no contravention of Article 1 of Protocol 1 of the *ECHR* and, therefore, no consequent incompatibility with the articles of the EC treaty in respect of issues pertaining to fundamental rights.

B. The EC Law Argument

Burton J gave leave to the claimants to amend the relief sought with respect to EC law. The amended relief was as follows:

A declaration that the Regulations and the Finance Act are incompatible with European Community law as being:

- (a) an unnotified State aid contrary to Articles 87 and 88 EC in respect of the following areas of business activity:
 - (i) Information Technology

78 (1983) 32 DR 266.

79 (1985) 45 DR 211.

80 The PCG case [2001] EWHC Admin 236 [43].

81 *Ibid* [47].

82 *Ibid* [48].

83 *Ibid*.

84 *Ibid* [49].

- (ii) Engineering (including oil and gas)
 - (iii) Telecommunications
 - (iv) Management and Business Consulting;
- (b) an unlawful hindrance to free movement of workers, freedom of establishment and freedom to provide services, contrary to Articles 39, 43 and 49 respectively; and cannot lawfully be applied.⁸⁵

The purpose of the amendment was to identify more specifically the areas of business activity adversely affected by the IR35, by way of the listing from (i) to (iv) above. These areas of business activity were described as being the ‘knowledge based sector’ or the ‘know-how industry’.⁸⁶

1. Articles 87 and 88

Article 87 of the EC treaty proscribes any aid granted by a member state ‘which distorts or threatens to distort competition’. Article 88 requires a member state to inform the Commission ‘in sufficient time to enable it to submit its comments of any plans to grant or alter aid’. The claimants asserted that the recipients of the unlawful state aid were their competitors, in the business areas specified in the amended relief, who were unaffected by IR35.

Burton J said that there were three questions to be answered:

1. Is there aid at all?
2. If so, to whom?
3. Is it identifiable with specificity? Is the person or undertaking or sector which is said to be benefited by virtue of the disadvantage imposed upon the complainant sufficiently identifiable as the recipient of aid from the Government? It must be recalled that this has been called, at least in the normal context of *positive aid*, the ‘selectivity principle’.⁸⁷

Pointing out that EC member states are given a broad leeway with respect to their direct taxation measures, his Honour referred to two Commission notices that assist in the application of the various articles of the treaty. One, entitled *Notice on Co-operation between National Courts and the Commission in the State Aid Field*⁸⁸, elaborates in paragraph 7 the notion of what may constitute ‘state aid’, including, for example, subsidies and tax concessions. The other notice, entitled *Commission Notice on the Application of the State Aid Rules to Measure Relating to Direct Business Taxation* provides:

The main criterion in applying Article [87] to a tax measure is ... that the measure provides in favour of certain undertaking in the Member States an exception to the application of the tax system. The common system applicable should thus first be determined. It must then be examined whether the exceptions to the system or the differentiations within that system are justified ‘by the nature or general scheme’ of the tax system, that is to say, whether they derive directly from the basic or guiding principles of the tax system in the Member state concerned ...⁸⁹

In the PCG case, the issue related to ‘negative aid’ rather than to ‘positive aid’ because the disadvantage to the claimants resulting from the imposition of tax and NIC liability gave a corresponding advantage to their competitors.⁹⁰ An example of positive aid would be a subsidy or a tax concession to one company, group or business sector. The case Burton J found most relevant was *R v Commissioners of Custom and Excise ex parte Lunn Poly*

⁸⁵ Ibid [16].

⁸⁶ Ibid [16-17].

⁸⁷ Ibid [60].

⁸⁸ [1995] OJ C 312/07.

⁸⁹ [1998] OJ C 384/03 [16].

⁹⁰ The PCG case [2001] EWHC Admin 236 [62].

*Ltd*⁹¹ ('*Lunn Poly*'). In *Lunn Poly*, the claimants were successful in arguing that provisions in the *Finance Act 1997* (UK) allowing differential tax rates to be charged on insurance premiums constituted unlawful state aid. The decision of the Divisional Court was upheld on appeal to the Court of Appeal.

In *Lunn Poly*, it was the same legislative measure that created the tax differential, so the 'selectivity principle' was readily applied. In the PCG case, the claimants argued that IR35 affected only some of the competing businesses specified in the amended relief, and this gave a corresponding benefit to those businesses that were unaffected. For Burton J, the fact that the claimants had to amend the relief sought to narrow the field of business activity affected by IR35 was evidence of the generality of the measure. He commented, '[i]t seems to me difficult, and in the present case impossible, to be able to spell out of a general measure, applicable to all sectors, a case of selective benefit within certain sectors'.⁹²

With respect to whether a measure constitutes state aid, Lord Woolf said, in *Lunn Poly*:

It is necessary to focus on the effect the introduction of the differential rate of tax had on the previous position in order to decide whether the change in rates constituted an aid ... It is here that the question of there being an objective justification for the implementation of the measure could be relevant.⁹³

In the PCG case, the claimants conceded that it was not the object of the legislation to grant unlawful state aid, but argued that that was the effect. Burton J found the measure to be a general measure which applied 'to persons in accordance with objective criteria without regard to location, sector or undertaking in which the beneficiary may be employed'. Although the claimants' competitors were not affected by IR35, they paid income tax and NICs for the equivalent employees. The measure was introduced to limit tax avoidance and 'was not, in the circumstances, an exception to or derogation from a general system, but was intended to ensure compliance with it'.⁹⁴ Accordingly, the measure did not constitute state aid under article 87, and was therefore not required to be notified under Article 88.

2. Articles 39, 43 and 49

Articles 39, 43 and 49 of the EC treaty relate to freedom of movement within the EC in various forms. In addition, article 50 provides:

Without prejudice to the provision of the Chapter relating to the right of the establishment, the person providing a service may, in order to do so, temporarily pursue his activity in the State where the service is provided, under the same conditions as are imposed by that State on its own nationals.

There are also articles relating to freedom of movement of goods (article 28) and of capital (article 56). Where the claimant argues that there has been a contravention of one of the articles relating to restriction of movement, the contravention of the relevant article must be shown by the claimant. The defendant may then attempt to justify the restriction, relying on the general principles of EC law. Any such a justification must not discriminate between nationals of different member states, must arise from pressing reasons of public interest and must be proportionate.⁹⁵

(a) Article 39: Freedom for Workers

Article 39 refers in particular to 'the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment'. In the PCG case, no discrimination or dislocation was alleged, however IR35 might encourage workers to leave the United Kingdom, or

⁹¹ [1999] Eu LR 654 (Court of Appeal) ('*Lunn Poly*').

⁹² The PCG case [2001] EWHC Admin 236 [67].

⁹³ *Lunn Poly* [1999] Eu LR 654 [663G-664A] (Court of Appeal)

⁹⁴ *Ibid.*

⁹⁵ *Ibid* [71].

discourage workers from going there. This would be an obstacle discouraging mobility. Evidence was raised that other member states have less favourable regimes with respect to one-person service companies, which made the United Kingdom an attractive location for service contractors. Burton J found that this argument was not conclusive as to the unavailability of article 39 because, as he put it:

(a) I suppose it could be said that the introduction of IR35 has meant that the incentive to come to the United Kingdom, which up to now there has been because it has apparently been more attractive for service contractors, has thus been removed ... and/or (b) I do not have evidence about the position in every other Member State ...⁹⁶

(b). Article 43: Freedom of Establishment

The freedom of establishment includes both a right not to be discriminated against and obstacles which do not have the effect of discrimination. The claimants' argument that IR35 constituted such an obstacle met the same fate, and for the same reasons, as the argument with respect to article 39.

(c). Article 49: Freedom for Services

Again, the claimants argued that IR35 would amount to an obstacle which would affect those who were established in another member state and who, while remaining there, wished to provide services in the United Kingdom. Burton J remarked that 'IR35 would only bite if the person or company was subject to United Kingdom taxation, and it would require continued establishment abroad but lengthy provision of services (perhaps rendering them the more likely to be treated as an employee) in the United Kingdom before the problem arose'.⁹⁷ Thus IR35 was unlikely to affect many, if any, service contractors established elsewhere in the EU who occasionally provided services in the United Kingdom.

3. The Defendants' Case

Although seemingly unenthusiastic about the claimants' arguments with respect to articles 39, 43 and 49 having been contravened by IR35, Burton J nonetheless turned to the defendants' case. The defendants argued that IR35 did not amount to a restriction, or obstacle, on freedom of movement 'simply by virtue of the fact that IR35 imposes an obligation on those in fact providing services as an employee to pay NIC on the remuneration paid by the client; or at least that the only incentive would be to avoid paying tax which would be payable both by all in the United Kingdom and, on the evidence, in many, if not most, other Member States'.⁹⁸ Without positively agreeing with the defendants at this point, Burton J indicated general acceptance of this approach.

In the alternative, the defendants argued that if indeed there was an obstacle or restriction on movement, it was justified. They raised three forms of justification: fiscal supervision, fiscal cohesion and tax avoidance. Burton J said the first two did not apply in the present case, but did find the third one relevant. After reviewing the case law on justification, his Honour concluded 'there is no European jurisprudence to prevent reliance by the Revenue in this case upon its object and effect of combating tax avoidance and/or reducing diminution in tax revenue'.⁹⁹

⁹⁶ Ibid [76].

⁹⁷ Ibid [80].

⁹⁸ Ibid [82].

⁹⁹ Ibid [97].

4. *Burton J's Conclusion on the Freedom of Movement Articles*

It was only with respect to article 49 (freedom for services) that Burton J considered the claimants might have a case, but he added that any restriction was justified by reason of combating tax avoidance. Having decided earlier that there were no human rights implications and no discrimination or lack of equal treatment, the only remaining issue was whether the restriction was proportionate (i.e. no more extensive than is necessary to achieve the aim or objective). This he concluded in favour of the defendant, so dismissed the challenge based on the contravention of EC law.

C. *The Appeal*

The PCG was refused leave to appeal initially. However, in June 2001, the right to appeal was secured. PCG Chairman Jane Akshar said:

Our members decided to fund an appeal against the High Court decision because we believe we have a good case and we want to fight for our right to run small businesses.

These people are hard working businessmen and women whose businesses are being damaged and in some cases destroyed because of unfair treatment by the Government. IR35 treats these entrepreneurs as if they are employees for tax and NI purposes and therefore prevents them from competing on a level playing field with their larger competitors.

It is ironic that our members have to fund a legal action against a Government which professes to support small businesses to protect our right to run a small business.¹⁰⁰

The appeal was dismissed in the Court of Appeal by Robert Walker LJ, Auld and Dyson LJJ concurring.¹⁰¹ Counsel for the claimants argued that Burton J 'found in their favour on almost all factual issues, and rejected their case on ... narrow points of law'. Counsel for the Inland Revenue, on the other hand, 'pointed out that the judge was from the outset sceptical as to whether there were major differences between the parties on factual issues (as opposed to differences of approach and mindset)'.¹⁰²

The claimants did not contest Burton J's decision in relation to Article 1 of Protocol 1 of the *ECHR*, but confined their appeal to the issues pertaining to state aid and freedom of movement under EC law.¹⁰³ Robert Walker LJ said that where the state imposed a detriment, it would only be state aid if it gave 'a corresponding advantage to identifiable business competitors of those who have to bear the detriment'. He also commented that he doubted whether Burton J's coining of the phrase 'negative aid' in this context was useful because it appeared 'to assume what has to be proved'.¹⁰⁴ After careful review of the cases that Burton J had considered, and not having been persuaded that Burton J's conclusions were wrong, Robert Walker LJ rejected the grounds of appeal based on state aid.¹⁰⁵

With respect to freedom for workers under article 39, Robert Walker LJ agreed with Burton J's findings, but for different reasons. Robert Walker LJ said IR35 was not an obstacle to anyone wanting to work in the UK, but might be an obstacle to 'someone who wishes to offer the sort of services which an employee would undertake, without having the status of an employee'.¹⁰⁶ Robert Walker LJ also dismissed the appeal on articles 39, 43 and 49. He was, however, critical of Burton J's approach to the matter of proportionality in the discussion at first instance of article 49. In Robert Walker LJ's view:

100 Professional Contractors Group, 'PCG Announces Legal Appeal Against Government' (Press Release, 28 August 2001) <http://www.pcg.org.uk/cms/index.php?option=com_content&task=view&id=210&Itemid=297> at 5 January 2009.

101 *Professional Contractors' Group v Commissioners of Inland Revenue* [2001] EWCA Civ 1945 (Robert Walker LJ, Auld and Dyson LJ, 21 December 2001) (the 'PCG appeal').

102 *Ibid* [17].

103 *Ibid* [26].

104 *Ibid* [34].

105 *Ibid* [49-51].

106 *Ibid* [70].

If proportionality were an issue in this appeal I would be inclined to think that the judge did not go far enough in asking himself whether the IR 35 measures were the least onerous which could be adopted in order to achieve their objective. In expressing that tentative view I am well aware of the difficulty of the task, and I sympathise with the judge's view that it was not for him to enter the political arena ...

All these consideration have led me to wonder whether it might not have been possible to bring forward measures which accorded some recognition to the existence of a sort of no-man's land between Schedule D and Schedule E, rather than insisting on the gulf which exists in theory (but not, always, in practice) between them. Such measures might still have contained robust sanctions against unacceptable tax avoidance. However it is not necessary or appropriate to express any final view, since in my judgment the appeal has fallen at an earlier hurdle. PCG and its members may continue to work through democratic means for amendment of IR 35 so as to meet their complaints, but they have in my judgment failed to strike it down under Community law.

The application for permission to appeal to the House of Lords was refused.¹⁰⁷

VI. CONCLUSION

There is an argument that the legislation was hastily introduced and that the inflammatory language used worsened the level of opposition to the measures. Certainly the public response was quite extraordinary. Professor Freedman notes that 'much of the anger generated by the provisions resulted from the concern of those who have legally utilised incentives in the tax and business organisation system, and who consider themselves to be contributing to the economy by setting up businesses, that they were being described as tax avoiders'. She does, however, suggest that some of this concern has been overstated.¹⁰⁸

It seems there was inadequate consultation, particularly with reference to the underlying rationale for the legislation, and the consultation focused on how to implement the rules rather than whether any alternative approaches would have made more sense. In addition, the government failed to promote convincingly any positive aspects of the proposed changes. One such undersold benefit was the better protection of those persons who would be better off being categorised as employees (if that is what they really were), rather than being treated as self-employed and lacking bargaining power in their relationship with the client.

There is some evidence that the Inland Revenue did not understand or appreciate commercial realities. People set up private companies for reasons other than tax avoidance. Use of the case law approach to determine applicability of the new rules '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'.¹⁰⁹

Resistance to the measures was at two levels. Client firms resisted the imposition of a new layer of administrative burden, requiring them to determine whether or not the arrangement was employment, and, if so, to pay national insurance contributions. Workers resisted the restrictions that the rules placed on their ability to arrange their affairs so as to minimise their own tax burdens. The measures finally enacted allow client organisations, for example the large software companies, to continue to shape the labour market in order to avoid their own employment obligations. However, arguably, this was inevitable in light of their more significant lobbying power vis-a-vis small, independent contractors.

¹⁰⁷ Ibid [93].

¹⁰⁸ Freedman, above n 58, 99.

¹⁰⁹ Ibid 100.