TAXATION OF WORKERS IN THE CONSTRUCTION INDUSTRY

AN ASSESSMENT OF *FALSE SELF-EMPLOYMENT IN CONSTRUCTION: TAXATION OF WORKERS*

INTRODUCTION

1. In July 2009 HM Treasury and HMRC jointly issued a consultation document entitled *False self-employment in construction*[1]. The document defines "false self-employment" as occurring where the underlying characteristics of a working engagement indicate that there is an employment relationship, but nevertheless the engagement is presented as self-employment[2]. Defined in this way, false self-employment is a form of tax evasion: for instance, it enables the engager to avoid paying employer's NICs on its payments to the worker. The premise on which the consultation document operates is that false self-employment is a particular problem in the construction industry[3].

2. Having identified the problem, the consultation document sets out a proposed solution, as follows[4]. Where an engager's main business involves the carrying out or commissioning of "construction operations", and the engager uses the services of a worker to carry out such operations, then for tax purposes any payments to the worker in respect of those services are to be deemed to be employment income, **unless** the

[1] Available online at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-

[2] See consultation document, paragraphs 1.2 and 2.3

[3] See especially paragraph 2.5-2.17 of the document.

[4] See section 5 of the document.

worker fulfils one or more of three proposed new statutory criteria. The proposed criteria are:

- **Provision of plant and equipment**. The worker provides the plant and equipment required for the job they have been engaged to carry out. This criterion is not satisfied if the worker provides nothing more than tools of the trade that individuals working in the industry customarily provide for themselves.

- **Provision of all materials**. The worker provides all materials required to complete a job.

- **Provision of other workers**. The worker provides other workers to carry out operations under the contract, and is responsible for paying them.

3. The consultation document draws extensively on a report entitled *The Evasion Economy*[5] co-authored by Mark Harvey and Felix Behling for UCATT, and apparently prepared in early 2008. The central term "false self-employment" is taken from the UCATT report.

4. The consultation period for *False self-employment in construction* ended in October 2009, and a summary of the consultation responses was published in March 2010[6]. There has been no further consultation on these or similar proposals following the May 2010 General Election, and nor has anything yet been done to implement them. There is at present no evidence of political pressure from the Opposition, or lobbying by other parties (e.g. trade unions) in favour of the proposals.

5. At first sight, then, the July 2009 consultation document might appear to be of historical rather than practical interest. In our view, it would be unwise for those involved in the construction industry to proceed on this assumption. In the current public spending climate, and with the post-May 2010 coalition government focused on

[5] Available online at http://www.essex.ac.uk/sociology/CRESI/Archive/Evasion_economy.pdf

[6] Available online at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/consult_construction_responses090310.pdf

efforts to reduce the public sector deficit, issues about increasing the tax take and tackling (perceived) evasion are high on the political agenda. Moreover, as we demonstrate in detail below, the tax position of the construction industry has long been of special interest to HMRC and successive Governments: under the various successive versions of the Construction Industry Scheme (CIS), an industry-specific tax regime has been in operation since 1971. When changes have been made to the CIS, there has sometimes been a lengthy period (several years) between initial consultation and eventual implementation. Given all of these considerations, it is reasonable to anticipate that the proposals in the July 2009 document may well be revived in future, particularly if there continues to be widespread adherence within Government to the assumption that "false self-employment" is prevalent in the construction industry.

6. The fate of these proposals is clearly important to all of those involved in the industry itself; but the proposals also have a wider significance. As we discuss in more detail below, the construction industry is a key sector of the UK's economy, and anything that affects its performance will have wider indirect consequences for the economy as a whole. Moreover, the question of how employment is to be distinguished from self-employment, and the taxation and employment law consequences of that distinction, are of broad general significance. If there is to be an industry-specific approach to defining employment status for the construction industry, will a similar approach also be adopted for other sectors of the economy? And with what result?

7. For all of these reasons the proposals in the July 2009 document require careful scrutiny. In this report we subject them to close analysis. We argue that the evidential basis for the proposals is weak; that their potential practical consequences are undesirable; and that they would constitute a wrong turning for UK tax and employment law. We suggest an alternative approach to tackling any perceived problems relating to construction industry taxation.

8. This report is divided into six main sections, dealing with the following topics.

   (i) The role of the construction industry within the UK economy.

(ii) Historic approach to taxation of the construction industry: the development of the CIS.

(iii) The proposals set out the July 2009 document.

(iv) The problem of "false self-employment": is it substantiated by the 2009 document?

(v) Assessment of the July 2009 proposals and their consequences.

(vi) What is the right approach to false self-employment in the construction industry?

1. THE CONSTRUCTION INDUSTRY AND THE UK ECONOMY

9. The importance of the construction industry within the UK economy as a whole can readily be demonstrated. Taxation proposals affecting such a key sector of the economy are, inevitably, of wide general significance.

10. The industry covers an extensive range of activities, including the construction of:

- residential buildings (public and private);
- non-residential public structures (hospitals, schools, etc);
- commercial structures (shops, offices etc);
- industrial structures (factories, warehouses etc).

In addition to new construction, the industry also includes the repair, maintenance and refurbishment of existing buildings, and the construction and maintenance of the infrastructure and services required to support new and existing structures.

11. The construction industry contributes approximately £100bn a year, accounting for approximately 6% of UK GDP. It is the largest engager of manual workers in the UK, providing work for over 2.2 million people: the industry accounts for 7% of all workers and 4% of all employees in the UK. There are more than 300,000 construction businesses in the UK, varying in size from small businesses with a single proprietor to corporations hiring thousands of employees and sub-contractors[7]. The construction industry as a whole contributed 4.5% of all tax payable in 2008-9 (the last year for which details are available)[8].

12. In the second quarter of 2008 the UK economy went into recession, and the construction sector also followed. Employment figures in the industry remained steady through 2008 and only started to fall slowly in the fourth quarter.

13. Subsequently there have been some signs of recovery in the construction industry, with output rising almost 10% during 2010[9], although average tender prices appear to be falling[10]. Nevertheless, the outlook is still very mixed: the public sector, a major customer of the construction industry, is set to reduce investment in new construction as public spending cuts take effect. At the same time, costs continue to rise as improving demand and global uncertainties increase commodity prices; tender prices overall are not expected to increase during 2011[11]. Main contractors appear to be trying to diversify into infrastructure projects (including energy and waste), needing flexibility to move into new markets[12].

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[7] Labour Force Survey, May 2011; Office of National Statistics, May 2011

[8] Table T11.5, HMRC Corporation tax statistics 2011

[9] Revised *Quarterly National Accounts* for Q4, 2010, Office of National Statistics

[10] Davis Langdon Index, April 2011

[11] Davis Langdon Index, April 2011

[12] Davis Langdon Index, April 2011

14. The March 2011 Budget included some measures which may assist the residential construction industry, including the new FirstBuy Scheme to assist first time buyers, the release of public land for house-building, and the relaxation of planning laws to enable conversion of vacant office space to residential use. The proposed revision of the Real Estate Investment Trust tax reliefs may also assist the sector in obtaining funding. While all of this will assist house-builders over the next few years, it does little for the rest of the construction sector.

2. TAXATION OF THE CONSTRUCTION INDUSTRY: THE CIS

15. The construction industry has long been subject to its own industry-specific taxation regime, via the different successive versions of the Construction Industry Scheme ("CIS"). An understanding of the CIS is essential in addressing the July 2009 proposals: the proposals take the CIS as their point of departure, while at the same time assuming that the CIS is unsatisfactory in its present form

16. In this section we discuss the history of the CIS in some detail. We also outline some of the most important recent tax cases about employment status in the construction industry; again, these are essential background in understanding and assessing the July 2009 proposals. We trace the story, in outline, from the early 1970s to the present day, beginning with the introduction of the first version of the CIS in 1971[13]. As the history demonstrates, the revenue authorities have long taken a special interest in the tax position of the industry.

[13] There is a useful summary of the history of the CIS in the House of Commons Library Standard Note on Taxation in the Construction Industry (SN/BT/814), last updated 20th May 2011.

Developments in the 1970s: first version of the CIS

17. The first variation on the construction industry scheme was introduced in the Finance Act 1971, to prevent evasion of tax by self-employed contractors about whom the Revenue had little knowledge. The object of the scheme was "[to prevent] those who lacked the discipline to operate a business in a professional manner from obtaining gross payment status"[14]. Whether or not this was justified is beyond the scope of this report.

18. Workers in the construction industry in the UK have consistently shown a preference for self-employment over the years[15], in some cases because it was considered to provide opportunity for individuals to avoid income tax and National Insurance Contributions altogether. The self-employed were referred to as being "on the lump": the term derived from the practice of being paid in a lump sum for a piece of work, rather than receiving wages (referred to as being "on the books"). During the 1960s, this term led to a practice of referring to untaxed construction workers specifically as "the lump"; this was the impetus for the introduction of the Construction Industry Tax Deduction Scheme, or CIS.

19. Hence the main purpose of the scheme was to collect tax from those who were currently operating within the black economy and evading tax altogether. The scheme was not intended to address whether those were paying tax on a self-employed basis ought instead to be taxed as employees.

20. As introduced by the Finance Act 1971, the CIS was in two parts. The first was known as the "714 Certificate Scheme"; it allowed sub-contractors (both self-employed and corporate) to obtain a 714 certificate, which permitted them to be paid

[14] Finance Bill 2004, Clause 57, Explanatory Notes, Note 7

[15] Nesbit, P. (1997), "Dualism, flexibility and self-employment in the UK construction industry", *Work, Employment and Society,* Vol.11 No.3, pp.459-479

gross by the engager. The sub-contractor then paid tax in the usual way, after the end of the tax year, on profits after deduction of expenses. A subcontractor could obtain a 714 certificate by satisfying the Revenue that he was likely to pay tax on his profits; the decision was based on the previous track record of tax compliance.

21. Where the sub-contractor could not produce a 714 certificate, payments were made under the second part, the "SC60 Scheme". This required the engager to deduct tax at the basic rate from any payments made to the sub-contractor. The sub-contractor then completed a tax return at the end of the year to finalise any tax still outstanding, or to obtain any refund due from HMRC, by reference to profits after deduction of expenses.

22. The key difference between the 714 Certificate Scheme and the SC60 Scheme was simply in the timing of tax payments; those under SC60 paid tax throughout the year through the withholding mechanism, whereas those under 714 Certificates had the cash-flow benefit of retaining any sums due in tax until the due date for payment for the relevant tax year.

23. At the time of introduction in 1971, the emphasis of the scheme was on ensuring that the Revenue had knowledge of those working in the industry; the intention was to put in place a form of withholding tax, as there was thought to be a risk of loss of tax to the Exchequer. The same type of withholding applies in other areas where the Revenue consider that there is a substantial risk of loss tax loss, usually in situations where the Revenue considers that it is difficult to identify or pursue the taxpayer, such as where the taxpayer is overseas. In these situations the rate of withholding tax is typically the same as under the SC60 Scheme: that is, the basic rate of income tax.

Revisions to the CIS: the August 1999 version

24. The black economy which the 714 Certificate Scheme and SC60 Scheme were intended to combat was not significantly diminished by the introduction of the schemes; the self-employed could still earn cash-in-hand from other sources, with the accompanying temptation to fail to declare the earnings to the Revenue. This, rather than reduced National Insurance Contributions, remained the biggest benefit of self-employment from a tax perspective.

25. In particular, 714 Certificates began to be traded between workers. The rules were revised in the late 1970s to make it more difficult to get a 714 Certificate, but without great success.

26. A decade or so later, the Government considered that the attempts to reduce the impact of the black economy in the construction industry through the 714 Certificate Scheme and the SC60 Scheme had not had the desired effect. In 1991 the Revenue issued a consultation document proposing a further tightening of the scheme.

27. It was eight years before the changes that arose out of the consultation process were implemented, with a new Construction Industry Scheme coming into operation on 1st August 1999[16]. The new scheme maintained the concept of certificates for those who could meet certain specified requirements. The requirements themselves were, however, made rather more rigorous:

    - Subcontractors had to reach a minimum turnover amount (£30,000) to qualify for a certificate permitting them to be paid gross (similar to the 714 Certificate Scheme), as well as satisfying business and compliance tests.

[16] The time lag between 1991 and 1999 is striking. It reinforces the point already made, that even though the proposals made in June 2009 have not yet been implemented, it cannot be assumed that they have been abandoned.

- Those who did not satisfy these requirements could, instead, obtain a registration card, permitting them to be treated as self-employed but with tax deducted from the payment (similar to the SC60 Scheme).

- Subcontractors had to have a tax certificate in order to be paid gross, but if they had a registration card then they could be paid with tax deducted at a lower rate (currently 18%[17]). With neither card nor certificate, tax had to be deducted at 30% from the payment.

- Businesses outside the construction industry could not participate in the scheme unless the average annual expenditure of the business on construction was more than £1m.

- Information had to be provided electronically.

28. The changes to the scheme also reduced the rate at which tax was deducted (in cases where deduction was necessary), so as to bring the deduction rate closer to the average tax rate payable by subcontractors; the deduction rate is currently 18%. The new scheme meant that more subcontractors were now subject to deduction of tax from payments received, and that subcontractors who could not produce a CIS card or certificate were not generally taken on as self-employed subcontractors. To prevent the market in 714 Certificates that had previously occurred, the new CIS cards and certificates carried a photograph of the subcontractor.

Further revisions to the CIS: the April 2007 version

29. Despite the introduction of these arrangements, a further consultation document on the CIS was released in November 2002, barely three years after the new scheme came into effect, and changes to the CIS were subsequently announced in the 2003 Budget.

[17] The rate of deduction was reduced from 23% to 18% with effect from the start of the new tax year on 6th April 2000.

These were implemented by the Finance Act 2004[18] and by regulations adopted in 2005[19]. The changes eventually came into effect in April 2007[20].

30. It was this consultation round (beginning in 2002) that introduced for the first time the concept of employment status directly into the Construction Industry Scheme. According to the 2002 consultation document, the proposed changes were thought necessary in order to:

- reduce the regulatory burden of the scheme;
- improve the level of tax compliance; and
- *help construction businesses to get the employment status of their workers right* [our italics].

31. The first point is a continuing theme of tax consultations, seeking a compromise between ease of administration and effectiveness of the rules. The second point had always been the focus of the different versions of the CIS from the early 1970s onwards (as noted above), addressing what was thought to be significant non-compliance with tax rules by elements of the construction industry within the black economy. The third point was, however, new to this round of consultation in the construction industry. Neither the original introduction in the 1970s nor the revised scheme in 1999 had considered the employment status of those in the construction industry. As already indicated, hitherto the main purpose of the scheme had been to collect tax from those who were currently operating within the black economy and evading tax altogether, rather than to address whether those were paying tax on a self-employed basis ought instead to be taxed as employees.

[18] See ss 57-77 and Schedules 11 and 12.

[19] The *Income Tax (Construction Industry Scheme) Regulations* SI 2005/2045.

[20] Implementation was originally due in April 2005. It was deferred to April 2006, and then to April 2007. The penalty regime for the new scheme was delayed by a further six months, to October 2007.

32. The reform of the scheme implemented in 2007 required a new employment status declaration by engagers operating within the CIS, stating that they had considered whether or not the subcontractor was genuinely self-employed. An engager has always had to consider whether a worker is self-employed or employed; that is not unique to the construction industry. What was new from 2007 was the monthly declaration by the engager on the CIS return that the status has been considered for each worker included on the return.

33. In January 2006 HMRC also introduced an online Employment Status Indicator (ESI) – applicable to engagers generally, not just those in the construction industry - to help engagers determine whether their workers were employed or self-employed. This online tool is necessarily rather blunt; if employment status could be easily decided by a checklist, the wealth of caselaw on the point would not exist. In practice, the ESI seems rather inclined to find the relationship to be one of employment in most cases; this is consistent with HMRC's preferred approach.

34. It is therefore somewhat surprising that the UCATT report[21] considers that the ESI betrays a "clear bias towards self-employment"[22]; this assertion is based on the fact that, if a worker is required to correct work at their own expense, then the ESI will generally rule that the worker is self-employed. The UCATT report considers that this is inappropriate given that "many disciplinary procedures typical of employment entail the reduction of pay for unsatisfactory work, or the correction of errors in one's own time" (page 48). In the experience of the authors (and other employment lawyers whose views were sought) it is not the case that employment disciplinary procedures characteristically require such a reduction or correction.

35. The changes made to the CIS in 2007 did not, however, alter the way in which employment status was determined: the tests developed through case-law continued to apply to the construction industry in the same way as for other economic sectors.

[21] *The Evasion Economy* co-authored by Mark Harvey and Felix Behling for UCATT; see paragraph 3, above.

[22] Footnote 10, page 48

Indeed, it is instructive to see how the 2002 consultation document addressed the issue of employment status. The first chapter of the 2002 document, looking at problems with the existing system, stated:

The Registration Card (CIS4) is (incorrectly) treated by some in the Industry as an indication that the subcontractor holding it is self-employed. As a consequence, some contractors do not independently check the employment status of the subcontractor once they have been presented with a Registration Card (CIS4). Some in the Industry claim that this leaves those businesses that correctly comply with their tax obligations at a commercial disadvantage.

The document indicated that an employment status declaration would be introduced, confirming that contractors had considered the employment status of the subcontractors they are taking on, and that this would be an important step towards dealing with concerns about "false" self-employment in the industry. However, the document also stated that it would not be appropriate (as some people had suggested) to move all Registration Card (CIS4) holders on to PAYE. This was because employment status is an issue that impacted on all industries, not just construction, and it would be wrong to look at its operation in the construction industry in isolation.

36. Nevertheless, the Revenue's focus on employment status within the construction industry had undoubtedly sharpened with 2002 consultation exercise, and enquiries into employment status of self-employed subcontractors intensified from 2002 onwards. In due course this led to legal challenges to determinations that certain construction industry workers were employees. From the Revenue's point of view, the outcome was very mixed. During the period from 2006 to 2009, the Revenue lost three significant construction industry employment status cases: *MAL Scaffolding*[23], *Castle Construction*[24] and *JL Windows and Doors*[25]. During the same period, they

[23] *Mark Andrew Lewis (t/a MAL Scaffolding) v Revenue & Customs* [2006] UKSPC SPC00527

[24] *Castle Construction (Chesterfield) Ltd v Revenue & Customs* [2009] STC (STD) 97

won only one significant construction industry case: *Wright*[26]. The facts of the latter made it clear that the engager was endeavouring to avoid employer's NICs. In the cases of *MAL, Castle* and *JL Windows* however, the Special Commissioners concluded that the relevant workers were genuinely self-employed, using the standard tests developed in the employment case-law.

37. These cases are highly significant in our view: they cast doubt on the claim in the July 2009 consultation document that there is widespread false self-employment in the construction industry. We discuss the cases in more detail later in this report.

Research into the operation of the new CIS[27]

38. In January 2008 HMRC published research on the impact of the new CIS[28]. Although there were some negative comments (primarily from smaller contractors with very few sub-contractors), the overall reception of the new scheme was positive. In reply to a Parliamentary Question in October 2008, the Government stated that about 10,000 businesses that had been entitled to receive gross payments had had their status revoked and were now being paid under deduction[29]. To put this figure in context, in

[25] *J and C Littlewood (t/a JL Window & Door Services) and Mark Molloy v Revenue &* Customs [2009] UKSPC SPC00733

[26] *P J Wright v HMRC* [2009] UKFTT 53 (TC)

[27] See the useful summary in section 8 of the House of Commons Library Standard Note on Taxation in the Construction Industry (SN/BT/814).

[28] *Exploring the early effects of the New Construction Industry Scheme (New CIS) – HMRC Research Report 40,* January 2008.

[29] HC Deb 27 October 2008 c777W.

November 2009 Government confirmed that just over 1 million individuals and businesses were registered under the new scheme[30].

39. In October 2010 the department published further research on the CIS[31]. This sought to determine whether the scheme had met its policy aims of: (i) making it easier for businesses to comply with their income tax obligations; and (ii) reducing the regulatory burden through making the scheme simpler to administer. On the basis of a survey of the industry, the overall assessment of the new CIS was positive. 81% of all respondents agreed that CIS was effective in ensuring that construction businesses pay income tax. 79% of respondents agreed that the existence of the scheme made them confident that construction businesses were complying with their tax obligations.

Context for the 2009 proposals

40. In July 2009 HM Treasury and HMRC released the consultation document with which this paper is primarily concerned, focusing on what was described as "false self-employment", and setting out proposals for a construction industry-specific definition of self-employment. Those unable to meet the definition would be required to be taxed as employees. The workers in *MAL, Castle* and *JL Windows* who were found by the Special Commissioners to be self-employed would all have been deemed to be employees under the proposals in this consultation document.

41. The history set out above provides essential context for these proposals. As will be apparent, in various respects the proposals build on the CIS; yet they also assume that the CIS does not provide a satisfactory solution in its existing form to the taxation of construction industry workers. This is despite the broadly positive assessment of the new CIS in the research we have summarised above. The 2009 proposals adopt the

[30] HC Deb 12 November 2009 c801W.

[31] HMRC, *Evaluating the Construction Industry Scheme: Research Report 106*, October 2010.

approach that was specifically rejected in the 2002 consultation document, namely, an industry-specific approach to employment status. The July 2009 document draws on some of the case-law discussed above; but its discussion of those cases is highly contentious.

42. The next section gives a more detailed account of the July 2009 proposals.

3. THE JULY 2009 PROPOSALS: THE CONSULTATION DOCUMENT

43. As already explained at the start of this paper, the July 2009 consultation document:

- identifies "false self-employment" as a particular problem in the construction industry; and
- proposes to adopt an industry-specific test of self-employment, for tax purposes, in order to address the (supposed) problem.

44. The concept of false self-employment is therefore central to the proposals, and section 2 of the consultation document begins by explaining what this means. According to paragraph 2.3, false self-employment occurs where the underlying characteristics of the relationship are employment but the relationship is presented as self-employment. This is stated to be driven primarily by three differences between the tax and national insurance treatment of the self-employed and the employed:

- employer's NICs are due on payments to employees, but not on payments to those engaged on a self-employed basis;
- the self-employed pay NICs at a lower rate than the employed; and
- the self-employed are taxed on the profits of their business, and the rules on what they can deduct from their gross income are more generous than those applied to employment income.

The consultation document suggests that these differences give workers and engagers a financial incentive to attempt to portray their employment income as being income from self-employment. There is also a brief reference to non-tax pressures operating in the same direction (e.g. the costs for employers of holiday pay and pension contributions); however, the primary focus of the document is on the tax and NIC implications of self-employment.

45. Ostensibly, then, false self-employment occurs when workers and engagers are, on a proper application of the existing legal tests, in an employment relationship, but misrepresent the nature of that relationship for the financial benefit of one or both of them. It is a form of tax evasion. This way of describing the problem assumes that the existing legal tests are satisfactory, but that workers and engagers are failing to apply them properly.

46. The document goes on to explain why false self-employment is thought to be a particular problem in the construction industry (paragraphs 2.5 - 2.17). Three main points are made:

- There is a much higher proportion of self-employed workers in the construction industry than in other sectors.
- HMRC compliance activity and statistical evidence points towards there being a substantial number of workers in the industry working under employment terms but being presented as self-employed.
- In 2007/08 there were some 300,000 labour-only subcontractors in the CIS, and the Government believes that a large proportion of these are in fact working under employment terms.

47. The document identifies various techniques that are allegedly used to present an engagement as self-employment. This includes the use of contracts prepared by specialist advisory firms and intended to achieve this effect, notwithstanding that the contractual terms often bear little relationship to the reality of the working

relationship: see paragraphs 2.9–2.10. There is also reference to the growing use of intermediary structures in the construction industry, and it is alleged that these are often set up with the intention that workers should have self-employed status: see paragraphs 2.11-2.15.

48. What section 2 of the document does not address, though, is the following question: if false self-employment (as defined) is rife in the construction industry, why are there not numerous decided cases where the worker and engager are found to have mischaracterised their relationship in the manner described by the consultation document? As was pointed out above, in four significant construction industry cases between 2006 and 2009 the Revenue was successful only in one case. The consultation document asserts that a slight change in the presentation of the facts can have a significant impact on outcome (paragraph 2.8), and that it is challenging and time-consuming for HMRC to build a full and accurate picture of the true terms of the engagement (paragraph 2.10). Paragraph 2.8 is supported by citations from the Special Commissioner in the *Wright* case, referring to the differences between that case and the *Castle* case (which was decided by the same Special Commissioner). These passages of the consultation document appear to be making a complaint that the existing law is hard to apply, rather than that it is being systematically evaded. Indeed HMRC's real concern may be, *not* that workers and engagers are misapplying the existing law, but, rather, that the application of the existing law means that people are treated as self-employed notwithstanding that in the eyes of HMRC they ought to be employees. On this view "false" self-employment would mean simply "self-employment of which HMRC disapproves".

49. Having described the problem of false self-employment, the document goes on to describe the problems that it causes (section 3). These are said to be threefold (paragraph 3.1):

- for the industry, an unfair competitive advantage for businesses that disregard their PAYE and NIC obligations;

- for the worker, a loss of entitlement to Jobseekers Allowance and Secondary State Pension and a lack of long term job security and career opportunities[32]; and

- for the Exchequer, a loss of revenue, as the correct amount of income tax and NICs is not being paid.

50. The cost to the Exchequer of less tax and NICs being paid as a result of false self-employment is estimated to be about £350m per annum: paragraph 3.5. As to the number of falsely self-employed workers, paragraph 3.6 baldly states that it is *likely* that the 300,000 or so sole traders operating as labour-only subcontractors in 2007/08 were engaged on employment terms. This goes further than the suggestion made earlier in the document (at paragraph 2.6) that *a large proportion* of these 300,000 individuals were really employees.

51. For comparison (at paragraph 3.7) the document refers to two other estimates:

- the Government's previous estimate that there were 200,000 falsely self-employed subcontractors;

- Professor Harvey's report, for UCATT, on *The Evasion Economy*, which had put the number of workers affected by false self-employment at approximately 400,000.

52. Section 4 of the consultation document summarises the action taken in the past. It refers to a number of the points that we have already discussed: e.g. the development of the ESI, and the declaration introduced in the new CIS return in 2007 requiring confirmation that the issue of employment status had been addressed by the engager.

53. The document also refers (paragraph 4.4) to the restructuring of compliance activity by HMRC, with the deployment of additional staff in specialist construction industry teams. What is lacking, though, is any account of whether this additional compliance

[32] The issue about job security and career opportunities must surely relate to whether the worker is an employee for the purposes of employment rights rather than for tax purposes. The consultation document is proposing to change the latter, not the former. We return to this point below.

activity uncovered evidence that substantiated the assumption of widespread false self-employment in the industry. Instead, there is the rather bland statement that:

it became clear that compliance activity on its own could not provide a solution.

There is no explanation as to when, or how, this became clear.

54. As in section 2 of the document, the impression given is that Government knows *a priori* that false self-employment is rife in the industry; so, if enforcement activity or case-law does not appear to bear this out, then this is taken to be because of the difficulty of applying the law and the ingenuity of workers and engagers in evading it, rather than because the initial assumption is questionable and requires reconsideration.

55. Section 5 sets out the proposed solution. Paragraphs 5.1–5.2 summarise the general approach, as follows:

The Government believes that the introduction of legislation, which moves away from the current case law approach and applies specific criteria to the engagement of workers in the construction industry, is the best way to address the issue of false self-employment.

The Government is seeking to design a solution for the construction industry which would ensure that those who are receiving payments for engagements that in reality amount to employment have the correct amount of income tax and National Insurance (NICs) applied to those payments. It would not define employment or self-employment for tax and NICs more generally, or for employment law.

56. The proposed industry-specific solution is then explained. It would apply where the main business of the engager involves the carrying out or commissioning of "construction operations", as defined for the purposes of the CIS (under section 74 of the Finance Act 2004). So, for example, if the worker is providing services to a

householder for work on a domestic property then the new provisions would not apply[33].

57. Three criteria are identified (paragraph 5.11), which the Government regards as being reliable indicators, within the context of the construction industry, of the worker being in receipt of self-employment income:

(i) Provision of plant and equipment – the worker provides the plant and equipment required for the job they have been engaged to carry out. This will exclude cases where the worker provides no more than such tools of the trade as it is normal and traditional in the industry for individuals to provide for themselves.

(ii) Provision of all materials – the worker provides all materials required to complete a job.

(iii) Provision of other workers – the worker provides other workers to carry out operations under the contract and is responsible for paying them.

A worker who falls within the scope of the new rules will have to meet at least one of these three criteria – otherwise he will be deemed for tax and NIC purposes to be in receipt of employment income.

58. The document asserts that, applying the existing case-law tests, the presence of one or more of these three criteria would be sufficient to indicate self-employment (paragraph 5.14). This may well be correct. However, the converse does not follow: under existing case-law, the *absence* of all three criteria would not be sufficient to establish *employment*. Otherwise the *MAL, Castle* and *JL Windows* cases, referred to above, would have been differently decided. So there is a category of workers who would, quite properly, be treated as self-employed at present, but who would fall to be treated as employees under the proposed new provisions. As far as this category of workers in concerned, there is no problem of false self-employment: unless, as remarked

[33] See paragraph 5.5 of the document.

above, what this term really means is that HMRC thinks that there *ought* to be an employment relationship.

59. The proposals recognise that the engager and the payer will not necessarily be the same person or body (see paragraph 5.6): the payer might be engager itself, but might instead be an employment agency or an intermediary. It is the work done for the engager that will be relevant, both in determining whether the proposed new rules apply to the engagement and in judging whether any of the three criteria are met. But it is the payer who will be responsible for actually applying the new criteria and deciding how payments should be made to the worker (see paragraph 5.6 and 5.18).

60. Where the engager and the payer are the same, PAYE and NICs (including employer's NICs) will be due on the full amount. Where the payer is an intermediary then different provisions may apply[34]. In the absence of information or evidence as to whether the criteria are met[35] the default position will apply, that is, the income will be deemed employment income (see paragraph 5.19). If the worker provides services through a company which they themselves control – a personal services company – then the proposed new deeming provisions will need to be applied first, before considering the intermediaries legislation (i.e. IR35[36]): see paragraph 5.21. Likewise where the worker is placed by an employment agency the deeming provisions will take precedence over the agencies legislation[37]. However, where the worker provides

[34] See paragraph 5.17, which states that the definition of "payment" in the Managed Service Company legislation may be adopted.

[35] Where the engager is also the payer then this should not arise; but if the engager and payer are different then the payer may be dependent on the worker and/or the engager to provide the necessary information, and this may not always be forthcoming.

[36] See chapter 8, Part 2 *Income Tax (Earnings and Pensions) Act 2003* and *Social Security Contributions (Intermediaries) Regulations 2000* (SI 2000/727).

[37] See paragraph 5.23. The agencies legislation is in Chapter 7, Part 2 of the *Income Tax (Earnings and Pensions) Act 2003* and *Social Security (Categorisation of Earners) Regulations* 1978 (SI 1978/1689).

services through a Managed Service Company, the Managed Service Company legislation will take place over the new deeming provisions[38].

61. Section 6 addresses the impact of the proposed new deeming provisions. It begins with the striking assertion[39] that the deeming provisions would apply only to those workers who would in any case be considered to be employees "if the existing case law tests had been properly and diligently applied". By implication, then, HMRC's failure in cases such as *Castle Construction* must have resulted from a want of diligence by somebody: whether on the part of the Revenue, the Special Commissioner or somebody else is not explained.

62. The main points made in relation to impact are these.

- There will be some limited increase in administrative burdens; but on the other hand the cost of compliance ought to be reduced by the introduction of a set of simple criteria.

- By tackling false self-employment, the provisions would remove two distortions to competition: first, between compliant and non-compliant construction industry firms; and secondly, between the construction industry as a whole and other sectors of the economy where false self-employment is not widespread.

- There would undoubtedly be attempts to circumvent the provisions, and the proposed new legislation would include anti-avoidance mechanisms.

63. Section 7 summarises the questions raised, and explains the consultation process. An Annex to the document contains an impact assessment, with a supporting evidence.

[38] See paragraph 5.22.

[39] Paragraph 6.2.

4. IS THE PROBLEM OF "FALSE SELF-EMPLOYMENT" SUBSTANTIATED BY THE JULY 2009 DOCUMENT?

The Commissioners appear to have approached their investigations on the basis that there must be an employment relationship … if one looks hard enough. Officers then went looking on that basis and persuaded themselves that they had found that for which they went looking.

(Special Commissioner Williams, Mark Andrew Lewis (t/a MAL Scaffolding v Revenue & Customs [2006] UKSPC SPC00527)

64. Over the past two decades, there has been an increasing tendency on the part of HMRC to reject claims by individuals to be self-employed wherever possible, in favour of bringing individuals within the PAYE system. The introduction of IR35 was an example of this, principally affecting the IT industry's use of contractors. Andrew Park J stated (in argument rather than in the judgment) in the Arctic Systems case (*Jones v Garnett* [2007] UKHL 35) that "the Revenue would have the whole world on PAYE if it could get away with it."

65. This tendency on the part of HMRC is also illustrated in the 2009 consultation document itself. Paragraph 2.8 discusses the difference in outcome between the *Wright* and *Castle* cases, which is put forward to illustrate how "a slight change in the presentation of the facts can have a significant impact on the decision reached". This suggests that the existing state of the law is seen by Government as unsatisfactory, because giving rise to finely-balanced or borderline cases. The reference to a slight change in presentation suggests that the law is both arbitrary (with minor factual differences leading to a divergence in outcome) and open to manipulation (*presentation* being presumably something different from the real substance of the case). If there is any validity in these criticisms then it is puzzling that the consultation paper only proposes to change the legal tests for a single industry sector; surely these

supposed deficiencies in the existing law would apply across the board, not merely to construction?

66. However, a comparison between the cases of *Wright* and *Castle* (the cases referred to at paragraph 2.8 of the consultation document) makes it clear that the facts of the two cases were actually very different. The cases were similar only in limited respects; there were significant differences with regard to the degree of control exercised over the workers, and the Special Commissioner had "no doubt that … the workers in [*Wright*] were employees", listing clear distinctions between the cases in his judgment (at §57). There is considerably more difference between the cases than a "slight change in presentation of the facts".

67. The points made in the consultation document about *Wright* and *Castle* suggest a frustration with the existing state of the law and a desire to change it; this is of course rather different from a concern that the existing law is being misapplied by engagers and workers.

68. This ambiguity makes it difficult to assess the document's claims about levels of false self-employment. In this section we nevertheless attempt an assessment; and for this purpose we assume that false self-employment means what the consultation document says that it means, that is, cases that are presented as involving self-employment where on a proper application of the existing law there would be an employment relationship. In other words, we assume that false self-employment is a form of tax evasion.

Are the numbers correct: individuals?

The UCATT report: the statistics

69. The UCATT report indicates that there are between 375,000 and 433,000 false self-employed individuals in the construction industry in the UK (see page 4 of the report). The reasoning is that "above a certain level [of self-employment], you can be fairly

sure of a range [of] numbers that are falsely and illegally self-employed. When the number goes above one quarter of the workforce, there begins to be suspicion of deviance from self-employment, and the more it goes above that level, the more suspicion turns to certainty" (page 11). The authors' attitude to self-employment in the construction industry might perhaps be best summed up by their comments (page 15) that "there is something distinctly deviant occurring within the UK construction industry. It is freakish."

70. Nowhere in the UCATT report is there a rigorous analysis of the UK construction industry, as compared with that in other countries; there is an assumption that the UK industry must be the same as that in all other countries, without considering (for example) the degree of pre-fabrication and automation that may be used elsewhere. There is also no attempt to assess the impact of the black economy elsewhere, or whether the apparently low figures of self-employment in other countries are, in fact, attributable to an absence from those figures of undeclared workers. The CIS was set up in the UK to attempt to minimise the number of such undeclared workers. It may be the success of that scheme that leads to the UK having accurate self-employment figures as compared to other European countries, with the official figures for self-employment in those other countries being reduced by the omission of undeclared workers. The UCATT report does not address this possibility.

71. The figure of between 375,000 and 433,000 is eventually explained (page 22) as being calculated on the basis that the true level of self-employment in the construction industry in the UK must be between 20% and 25%. The figure is taken on the basis that no other country exceeds 25% of their workforce as self-employed; again, no attempt has been made to consider (a) whether the figures for other countries are in fact accurate, and (b) whether the UK construction industry is in fact consistent with that in other countries.

72. The figures in the UCATT report are, therefore, apparently based on the assumption that there is something "deviant" in the UK construction industry and that rates of employment/self-employment must be immediately comparable to those in other

countries. The figures do not attempt any rigorous analysis of the industry or individuals within the industry

HMRC document: the statistics

73. The HMRC consultation document has not followed the UCATT report's figures when considering the potential scale of false self-employment; it disagrees with a number of the UCATT figures. For example, the UCATT report claims 50% self-employment in the construction industry (page 13). The basis for this figure is not explained. The subsequent figures on the same page are stated as being derived from the European Labour Force Survey 2007; but the Survey does not on its face support a figure of 50%, and if the UCATT report has derived its figure from the survey then it is wholly unclear how this has been done. The HMRC consultation document puts the rate of self-employment in the UK construction industry at 34%, based on the European Labour Force Survey 2007 (see paragraph 2.5 of the document), and this lower figure does appear to be supported by the Survey.

74. The consultation document states that "there is no obvious reason why the proportion of self-employed workers in the construction industry should be so high" but provides no indication that any analysis has been done on which to base this assertion. Instead, HMRC takes an estimate of 300,000 subcontractors within CIS as being those most likely to be falsely self-employed (paragraph 2.6) on the basis that these subcontractors did not claim any deduction for the costs of materials, nor for plant and equipment. In effect, they were labour only sub-contractors. HMRC "believes that a large proportion of these subcontractors … will in fact be working under employment terms" (paragraph 2.6), and later on revises this to an assertion that "it is likely that those subcontractors … (estimated to number 300,000 in 2007/8) … were engaged on employment terms" (paragraph 3.6). This assertion completely ignores the findings of the *Castle Constructions* and *MAL Scaffolding* cases, where workers who would be

within this category were found by the Special Commissioners to be self-employed. Whilst it is clear that some of these workers will be falsely self-employed (as, for example, in the *Wright* case), the courts have been able to use the existing tests of employment to distinguish between employment and self-employment within the construction industry, including among labour only sub-contractors.

75. The figures used as a starting point by HMRC (the 300,000 subcontractors not claiming deductions for materials and plant/equipment) would seem a more accurate place to start to consider the scale of false self-employment than the unadjusted comparisons with European levels of self-employment used by the UCATT report. However, it becomes clear that HMRC are not prepared to reduce that 300,000 estimate further to eliminate those genuinely self-employed who provide neither materials (because these are more cost-effectively sourced centrally) nor plant/equipment (because this is also more effectively sourced centrally – if each bricklayer turned up at a site with a concrete mixer, the site would be chaos). This is despite clear findings from the tax tribunal that there are certainly genuinely self-employed subcontractors within this category.

76. To revert to the distinction we have already made: it may well be that there are some 300,000 individuals whom the Revenue would like to see treated as employees. But this is a statement about how the Revenue would like the world to be, not a statement about the extent to which this group is evading the proper operation of the existing law.

Are the numbers correct: tax lost?

For these various reasons, and because employee and employer National Insurance Contributions (NICs) did not have to be deducted and paid in respect of sub-contractors, the hourly-rate paid to the workers was considerably higher than the rate

that would have been paid, had the workers been full-time employees doing the same work ...

A consequence thus of the clear intentions of the parties in this case is that the workers have been paid very considerably more than they would have been paid had the parties intended the relationship to be one of employment.

(Special Commissioner Nowlan, *Castle Construction (Chesterfield) Ltd v Revenue & Customs* [2009] STC (STD) 97)

There was no relevant evidence in this case, but I consider that I am making a very reasonable assumption when I say that workers engaged on a CIS basis are generally paid more than they would be paid if the same workers, doing the same work, were regarded from the outset as employees. Self-evidently the exposure to concede paid holidays and to pay employees when away from work through illness etc., coupled with the NIC liability of the employer to pay Class 1 secondary contributions "on top of salary" would all result in the salary being considerably lower than the rate of pay paid to self-employed sub-contractors. Thus, in a case such as the present, the retrospective calculation of liability to NICs is realistically based on more pay than would have been paid had the outcome of the case been known in advance

(Special Commissioner Nowlan, *Wright v Revenue & Customs* [2009] UKFTT 53 (TC))

The UCATT Report

77. The UCATT report estimates the loss to the Exchequer at a "minimum figure of £1.4bn per year" (page 31), based on an "average building worker's wage in 2007 [of]

around £475 per week". The average wage is derived from Housing and Construction Statistics in 2002, when the average wage was £411.

78. The figures also assume that each worker deducts £6,000 in expenses from profits each year, which the report inaccurately states "need no documentary verification". Whilst no documentary evidence needs to be submitted with a tax report, it certainly needs to be available and is required to be kept for seven years.

79. The UCATT estimate assumes that all falsely self-employed contractors would become employees if the existing rules were effectively enforced, and that they are earning the average construction industry wage. No consideration has been paid to matters such as:

- the actual average earnings of the self-employed in the construction industry;
- the likelihood that all self-employed contractors would in fact become employees;
- the associated increase in tax deductions for the engagers, reducing their tax bills; or
- the increase in claims for benefits available to the employed but not the self-employed.

80. The *Castle Construction* case made it clear that, in the case of that particular company, it would require approximately one-third of the number of employees to do the work that was done by the self-employed sub-contractors (see paragraph 4 of the decision in the case). If this is representative for the industry as a whole then it suggests that the UCATT report estimate should be very substantially reduced, even before any of the other points made above have been taken into account.

81. Based on the figures produced by the HMRC Impact Assessment (in the appendix to the June 2009 consultation document), 24% of self-employed construction industry

workers receive less than £5,000 in CIS payments each year, making an expenses deduction of £6,000 rather unlikely.

82. Essentially, then, the UCATT estimate of a £1.4bn tax loss is meaningless, as it assumes full conversion to employment and assumes that the self-employed are earning at the same rate as current full-time employees: both assumptions are unsustainable on the information available from HMRC and the tax tribunal decisions in this area.

HMRC: the July 2009 consultation document

83. The consultation document estimates that the "cost to the Exchequer of less tax and NICS being paid as a result of false self-employment is estimated to be in the region of £350m per annum" (§3.5). It does not use any of the figures from the UCATT report for this estimate. At first sight this might suggest a potential benefit of £350m from implementing the proposals and eliminating false self-employment; but in our view this would be unsafe and unrealistic as an estimate of yield.

84. The £350m estimate is based on the difference between tax and NICs payable on income from a self-employed worker compared with one in employment (see page 6 of the Impact Assessment annexed to the consultation document). The document does acknowledge, albeit not very clearly, that the potential yield will be reduced due to downward pressure on wage rates, changes in the level of expenses claimed, and "workers deliberately attempting to circumvent the legislation" (i.e. an increase in the black economy).

85. What is missing from this calculation is are the following additional points, which will drive down any potential benefit to the Exchequer still further.

- Any increase in payments of NICs by those engaging workers will lead to a reduction in corporate tax receipts, as the NIC payment will be tax deductible for the engager.

- Any increase in employment rates will lead to an increase in those eligible for benefits for the employed, and these are considerably higher than the benefits for the self-employed. The Impact Assessment considers that 24% of affected subcontractors receive less than £5,000 in CIS payments each year: these are likely to be people who would qualify for benefits if considered to be employed.

- If the proposals are implemented, there would be likely to be a substantial reduction in those working in the construction industry. If engagers will have to apply PAYE/NICs to an increased proportion of their workers, it is likely that they will seek out full-time employees to minimise costs and disruption (it is estimated that payroll administration costs are 10-20% of all payroll costs).

As we have already pointed out, the *Castle Construction* case made it clear that, if the company used full-time employees, it would need only 150 employees to cover the work done by 450 self-employed subcontractors over the course of the year.

86. Taking all these factors into consideration, the estimated benefit to the Exchequer if the proposals are implemented is likely to be considerably less than £350m per annum.

Conclusion

87. In practice, it seems likely that the supposed problem of mass false self-employment leading to substantial losses to the Exchequer cannot be properly substantiated.

88. The UCATT report figures do not appear to be based on any analysis of the UK market, but rather on a comparison with European countries which may in itself be flawed given the divergence with the figures for self-employment produced by HMRC

from (apparently) the same report. The estimated loss to the Exchequer requires unsustainable assumptions about the conversion of self-employment to employment and does not take into account the impact of increased corporation tax deductions for engagers and increased benefits claims.

89. The figures produced by HMRC appear to be more closely based on evidence from the UK construction industry but do not take into account the information available from tax cases which make it clear that the courts would not agree with their assessment that all 300,000 subcontractors who do not claim for materials and plant/equipment must be employees. Whilst we do not dispute that there will be some measure of false self-employment in the construction industry, cases such as *Castle Construction* and *MAL Scaffolding* make it clear that a substantial number of that 300,000 are in fact genuinely self-employed.

90. HMRC's estimated loss to the Exchequer of £350m, on HMRC's own admission, cannot readily be translated into a figure for the potential yield if the proposals are implemented[40]. Like the UCATT report, the consultation document fails to take into account the impact on corporation tax and benefits payments of a switch to employment status for the individuals involved. It is unsafe to assume that if the proposals were implemented then there would be a benefit to the Exchequer of £350m, or anything approaching that figure.

5. IMPLICATIONS OF THE JULY 2009 PROPOSALS

91. We suggest that the implications of these proposals can be analysed from four points of view:

(i) any benefits to HMRC and to Government generally;

[40] See page 3 of Annex A to the consultation document, where it is stated that the yield to the Exchequer would be subject to behavioural responses from the legislation and has not been assessed.

(ii) impact on workers in the construction industry;

(iii) impact on engagers operating in the industry; and

(iv) impact on the tax and employment system generally.

Anticipated benefits to Government

92. The main potential benefit to HMRC and to Government generally is an increase in the tax take, reversing any loss attributable to false self-employment.

93. As explained above, the UCATT figure of £1.4 billion for the loss attributable to false self-employment seems to us to be wholly unrealistic as a starting-point. The HMRC figure of £350 million is more modest; but it assumes that there are some 300,000 falsely self-employed individuals in the construction industry, and in our view this estimate cannot be substantiated. Even if the 300,000 figure is taken at face value, however, it cannot be assumed that implementation would deliver an annual benefit of £350m to the Exchequer, or anything like it. We have already identified a number of factors that will tend to reduce the yield.

94. The consultation document itself is strikingly coy on the subject of yield. The summary of analysis and evidence, at page 3 of Annex A to the document, includes the statement that:

The yield to the Exchequer would be subject to behavioural responses from the legislation and has not been assessed [our emphasis].

95. Any financial benefit to the Exchequer is in our view speculative, and at best likely to be modest. A comparison with the history of IR35 is instructive here. The impact assessment just before IR35 was introduced predicted a gain to HM Treasury of

£1.1bn over a 5 year period. Data released in 2010 showed a tax take of only £9.5 million, less than 1% of the predicted gain.

96. Historical evidence from the 1990s casts further doubt on whether there would be a significant tax benefit from the proposals in the 2009 consultation document.

97. In 1997, the Revenue and the Contributions Agency (which at that time were separate entities) launched a "clampdown" on self-employment in the construction industry. No new legislation was introduced; the clampdown was in the form of reviews of construction businesses, inspecting them and requiring them to demonstrate that workers were genuinely self-employed. Smaller construction businesses bore the majority of the burden of the clampdown, as the major companies generally sub-contracted to smaller intermediaries rather than dealing directly with workers.

98. The Labour Force Survey statistics for the late 1990s indicate that the clampdown had the effect of increasing employment, and slowing the increase in self-employment, in the construction industry.

99. It had been supposed that the clampdown would lead to a significant increase in construction costs, as self-employed workers were moved into direct employment by the companies engaging them. In the end, however, there was no significant evidence in the late 1990s of any increase in overall construction costs, indicating that these were not being passed along into higher tender prices. Neither wage costs indices nor tender price indices show any upward movement in the late 1990s that is inconsistent with normal industry trends. Accordingly, it remains likely that – as indicated by the Special Commissioner in *Castle Construction* and *Wright* above – it was the workers who bore the cost of becoming employed in the form of lower incomes. This would of course translate into lower tax bills, thereby offsetting or negating any increase in tax receipts resulting from a move away of self-employment.

100. What about other potential benefits to HMRC or Government generally? It might be suggested that the adoption of a simpler test for employment status in the construction industry will reduce the cost to HMRC of securing tax compliance, since the new rules

will be easier to operate. While at first sight this may appear plausible, in reality there are a number of difficulties.

101. Undoubtedly there would be attempts at evasion, as the consultation document recognises.[41] For instance, artificial structures could be adopted whereby materials would be charged to workers who would then be reimbursed for them, in order to create an appearance of satisfying the new criteria for self-employment. So HMRC would need to devote resources to identifying and combatting these new forms of evasion. The changes could also lead some of those who are currently paying tax on a self-employed basis to operate instead as part of the black economy and to seek to avoid tax altogether. Quite apart from the cost to the Exchequer in lost revenue, any increase in the level of black market activity would also potentially increase the cost to HMRC in seeking to secure compliance.

102. From HMRC's point of view this is not a good time to introduce a new tax regime covering a major sector of the economy. Any new regime creates a need for training those who will need to operate it; and one effect of recent public spending cuts has been a considerable reduction in HMRC's training budget.

Impact on workers operating in the construction industry

103. As explained above, the proposals would be likely to lead to downward pressure on pay rates and levels of employment. The impact will be particularly serious for the lowest paid workers in the industry, particularly given the current uncertain outlook for the construction industry and for the economy as a whole. We think that there is particular scope for self-employed subcontractors (working variable numbers of hours) to be replaced by full-time employees: compare the *Castle Construction* case, where

[41] See paragraphs 6.11 – 6.13

if the company used full-time employees it would need only 150 individuals to cover the work done by 450 self-employed contractors.

104. The proposed changes are intended to affect employment status for tax purposes but not for the purposes of employment rights[42]. So there is a very real prospect that some workers could lose the tax advantages of self-employment, without gaining the increased security and legal protection (e.g. protection against unfair dismissal) that goes with being employees. Many workers would regard this outcome as being the worst of both worlds.

105. The discussion document suggests that changes in tax treatment will have beneficial consequential effects on the way in which workers are treated for employment law purposes. Paragraph 1.6 of the consultation document reads:

[The new test] will only deem a worker to be in receipt of employment income for the purpose of income tax and NICs and will not confer employment rights on a worker. However, the Government hopes that the tax changes would also engender a more appropriate treatment of workers throughout the industry, leading to a culture of responsible employers applying employment rights

106. The Government's reasoning appears to be that imposing one set of fresh burdens on the construction industry (namely, a more onerous tax regime) will encourage that industry voluntarily to assume a second set of burdens (a more onerous employment rights regime). This does not seem to us to be a realistic expectation, particularly at a time when the economic outlook for the industry, and generally, is at best uncertain.

107. The changes will involve applying a different test of self-employment to the construction industry and to other industries. So construction industry workers will be treated for tax purposes as being employees, even though if they worked under similar arrangements in another industry they would be treated as self-employed. This seems to us unfair as between construction industry workers and those working in other

[42] See paragraph 5.2 of the 2009 consultation document, which makes the point explicit.

sectors. The assumption behind the consultation paper appears to be that there will be no unfairness, since:

The introduction of the deeming provision is intended to apply only to those workers who would in any case be considered to be employees if the existing case law tests had been properly and diligently applied[43].

In our view the cases we have discussed – such as *Castle* – make clear that there is a significant group of employees who on a proper application of the existing law are self-employed, but who would nevertheless be treated as employees under the new proposals.

108. Indeed, the *Castle Construction* case is a striking illustration of the potential unfairness of these proposals from the point of view of workers. In *Castle Construction* the Appellant was a company that undertook building working as sub-contractor, providing bricklaying and other services. It employed permanent head office staff, quantity surveyors and "trainee" and "novice" bricklayers: but its other workers (the majority of whom were bricklayers) were treated as self-employed sub-contractors. The Special Commissioner commented (paragraphs 3 – 4):

[This arrangement] has suited virtually all of the workers who also relish the flexibility to come and go, much as they please, and to work for different contractors when that seems more attractive. The disparity in time worked by a random sample of the 321 workers whose status is in dispute in this case is not a theoretical matter with little reflection in reality. There is considerable evidence of workers commencing and ceasing engagements with regularity. On a different level there is a great disparity in time worked in each week by the people being engaged at any one time.

One of the unchallenged statistics given by Mr. Botham, the director in charge of the Appellant's day-to-day business, was that in one year the Appellant had engaged 450 individual bricklayers at times during the year, but would have only required 150 to

[43] See paragraph 6.2

do the same work, had the 150 operated as full-time employees, each working an ordinary full week.

109. The Revenue considered that the workers ought properly to be treated as employees for tax purposes. When the company notified its workers that pragmatically they would have to enter into employment contracts, many of them walked out in protest (see paragraph 6 of the decision). As a result the company decided to continue its existing sub-contract arrangements (with a few exceptions) and to appeal against the Revenue's assessment.

110. Later on in the decision (paragraph 107) the Special Commissioner returns to the subject of the workers' preferences and working patterns:

[F]rom the perspective of the workers, the self-employment status gave them two important flexibilities. It enabled them to switch engagements for more money, given the opportunity. It also enabled them to work the hours they wished. I was told that those with families and responsibilities would thus often take the opportunity to work full hours and take few holidays and breaks. Those who were only interested in earning enough for beer money at the weekend would work much shorter hours, once they had enough money for their beer and living expenses. In contrast to many of the reported cases, consideration of the weekly time-sheets shows that these flexible terms were the essence of the arrangement here, rather than merely some technical right to choose work times that was never exercised in practice.

111. Under the new proposals, the workers in *Castle* would be treated as employees for tax purposes. The genuine element of flexibility in their working arrangements – which was beneficial to and valued by both engager and workers – would count for nothing. These workers did not provide equipment, materials or the services of other workers: they were labour-only subcontractors. So they would come within the 300,000 or so workers whom the consultation paper regards as being "likely" (paragraph 3.6) to be falsely self-employed.

112. If the new proposals were implemented then there would be two possible outcomes for workers in this position.

- The engager would change its arrangements and introduce employment contracts (as the company in *Castle* proposed to do, before the workforce protested). If the facts of *Castle* are at all representative then this would lead to a significant reduction in the total workforce, with those who remained losing the flexibility that they valued.

- The engager would continue to operate its existing arrangements, but the workers would now be treated as employees for tax purposes (although not for employment law purposes).

From the viewpoint of the employees neither outcome would be satisfactory: yet if they had been working in another industry, neither of these scenarios would have applied, and instead the existing arrangements could simply have continued, with the workers being self-employed for all purposes. What this analysis demonstrates is that new arrangements would involve a real, and disadvantageous, disparity of treatment as between construction workers and those in other industry sectors.

Impact on engagers operating in the construction industry

113. The changes will impose additional financial and administrative burdens on the construction industry. To the extent that the tax take is increased, there will be an additional financial burden. There will in any event be an additional administrative burden. The industry already has to apply a special set of tax rules to those who are treated as self-employed (under the CIS scheme); it will now have to apply a further set of special rules in determining which individuals are to be treated as self-employed. The industry will then need to apply the existing legal tests when assessing employment status for the purposes of employment rights rather than taxation.

114. We question whether it is appropriate to impose these additional burdens on an industry that is still recovering from the recent recession. We summarised above, in section 1, the importance of the construction industry to the economy as a whole, and the uncertainty of its present economic outlook.

Impact on the tax and employment law system generally

115. From the point of view of the tax and employment law system the proposed changes seem to us to be thoroughly undesirable.

116. In the interests of having a system that is transparent and readily understood, we think that it is desirable for the test of employed status in relation to taxation to be assimilated to the test used in relation to employment rights. The *bifurcation* of employment status as between these two purposes is a source of legal confusion and administrative complexity.

117. The proposals do not seek to counter this bifurcation: instead they will add to it. And the proposals add an element of what might be termed *balkanisation*: i.e. even within the tax context, employment status is now to mean different things for different industries. Are there to be similar industry-specific schemes in the future? The proposals will make the tax and employment law system less coherent, not more so; still more, if they are treated as a precedent for future situations where there is a perceived problem in a particular industry.

6. WHAT APPROACH SHOULD HMRC NOW ADOPT?

118. In the light of the above discussion, we do not consider that the approach set out in the July 2009 document is an appropriate response to the perceived problem of false self-employment in the construction industry. So what should HMRC do instead?

119. We do not dispute that there is some level of false self-employment in the industry. However, in our view neither the UCATT report nor the July 2009 consultation document provides a robust assessment of the level of false self-employment; and neither of them makes good the proposition that the level is much higher in construction than in other industry sectors.

120. It is clear that HMRC are not satisfied with the current position with regard to construction workers' employment status. However, no evidence has been put forward to show that anything has changed since the HMRC consultation document published in 2002, where HMRC noted that forcing employment status on workers in a particular industry was not justified.

121. The latest revisions to the CIS regime were implemented only in 2007. The research into those revisions published in January 2008 and October 2010 suggests that they were working well: although after about 18 months some 10,000 businesses had had their gross payment status revoked, this figure needs to be seen in context, with over 1 million individuals and businesses being registered under the new CIS. To have produced a further consultation document in July 2009, so soon after the 2007 changes, suggests that HMRC were expecting a substantial number of workers to be re-categorised immediately following the 2007 changes. In our view it would have been preferable to wait until there was a significant period of experience in operating the new CIS, before producing a consultation paper proposing yet another set of extensive changes to the tax regime for the construction industry.

122. HMRC already have mechanisms to identify tax avoiders. Their failure to enforce PAYE/NICs in the tax tribunal (in cases such as *Castle*) indicates that the problem of

false self-employment is not as straightforward and pervasive as HMRC would like to suggest. What is perhaps more pertinent is that government cuts have made it increasingly difficult for HMRC to carry out enquiries into those organisations that it suspect may not be compliant. Information about the level of HMRC compliance activity is instructive here. The response to a Freedom of Information Act request made by freelancebuilders.co.uk[44] indicates that 1,205 businesses in the construction industry were classed as employment risk cases for review in 2009/10. By comparison, there were 118,643 businesses with more than one employee in the construction industry in 2009[45]. These figures suggest that HMRC has not yet made significant efforts to investigate the problem which they outline in their consultation paper. An investigation rate of barely 1% of all relevant businesses is not consistent with an industry with a fundamental non-compliance problem in respect of PAYE and NICs.

123. In relation to HMRC's approach to compliance, an important forthcoming change is that HMRC will have increasingly comprehensive information on companies available through the iXBRL tagging requirements recently introduced. The requirement is that companies use iXBRL to tag elements of their accounts: this comes into effect for returns filed after 31st March 2011 in respect of accounting periods ending after 1st April 2010. This tagging will make available to HMRC consistent data across the country, and so can only improve the information and statistics available to HMRC. Taken together with the existing CIS data submitted monthly to HMRC, this should enable them to more accurately identify any businesses whose results vary from the expected results for a business in that industry. In turn, this should assist HMRC in directing its enforcement activity more effectively.

124. We suggest, therefore, that the right approach involves the following:

[44] See http://www.freelancebuilders.co.uk/Page/The-Truth-Seeker

[45] *Construction Statistics Annual 2010*, Office of National Statistics

- making a proper assessment of the evidence available to date about the operation of the new (2007) version of the CIS;

- considering how the new iXBRL tagging requirements can assist in tackling issues about false self-employment, once there is evidence available as to how those requirements are working in practice; and

- re-examining enforcement approaches to the construction industry in the light of the above, and, if HMRC remains of the view that there is a fundamental compliance problem regarding employment status in the industry, devoting a commensurate level of enforcement activity to tacking that problem.

125. This less spectacular approach seems to us to be preferable to an approach that, for uncertain benefits, would fundamentally rewrite the usual rules on employment status, but for one purpose only (tax) and in relation to one industry only.

126. In the longer term what is needed is an integrated approach to questions of employment status, taking account of both taxation and employment rights, and applicable to all industry sectors. The July 2009 proposals would travel in exactly the opposite direction. In our view they would represent a wrong turning for tax and employment law, not only for the construction industry, but for the labour market as a whole.

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