# CHAPTER 26

# EMPLOYED OR SELF EMPLOYED?

## 26.1 Introduction

In the next chapter we shall take a look at legislation concerning personal service companies. However, to understand these rules we must first examine the distinction between whether a worker is employed or self-employed for tax purposes.

The tax legislation itself does not tell us whether a worker is employed or self-employed, so the distinction between the two is based on case law and on HMRC practice.

In the vast majority of instances it is obvious whether an individual is an employee or whether he is in business on his own account as a self-employed trader. However there is a considerable grey area in between the two.

## 26.2 The "MICE" test

To differentiate between employed or self-employed, we apply what we call the **MICE** test:

Mutual obligations
Integration
Control
Equipment

**"M" stands for mutual obligations**.

If a worker is an employee, his employer is under an obligation to provide him with work, and the employee is under a similar obligation to accept the work and to perform the tasks delegated to him. However, if a worker is self-employed, he will have no guarantee of work and even if work is offered to him he is under no legal obligation to accept the work offered. The existence of any mutual obligation between the parties will usually be obvious from any service contract between the two parties. Employees usually have an employment contract which sets out the terms and conditions under which they are to perform duties for their employer.

**"I" stands for integration**.

An employee will be integrated into the business of his employer. By this we mean that the **employee will usually have his or her own desk,** a **designated computer terminal** at which to work, **his or her own stationery**, access to **normal employee facilities** such as the staff restaurant, and will have unrestricted access to the employer premises. Employees will also be allowed to join company pension schemes and receive invitations to staff functions such as Christmas parties. Contrast this with the position of a self-employed person, who will not be integrated into an employer's business and will not have a desk or a computer or access to the employer premises.

**"C" stands for control**.

In a typical employer/employee relationship, the **employee will exercise very little control over what he or she does on a day-to-day basis.** An employer will typically tell an employee what to do, how to do it and when to do it by. There is typically a master/servant relationship between an employer and an employee. On the other hand, a self-employed person will have far more control over the jobs that he or she undertakes and the deadline for completion of those jobs.

**"E" stands for equipment**.

When considering whether a worker is employed or self-employed, HMRC will look at who provides the tools of the trade. An **employee is rarely responsible for providing his or her own equipment**. When we turn up for work we expect our employers to provide us with a computer, a telephone, a fax and some stationery etc. A self-employed person, on the other hand, will customarily be responsible for providing the equipment to enable him to undertake the work offered.

## 26.3 Other criteria

There are a few other criteria to apply in determining whether a worker is employed or self-employed. We can look at the **degree of financial risk** taken by the worker. If the worker has no financial risk, has no opportunity to directly profit from the work undertaken and is not responsible for bearing any losses incurred in the course of his work, it is highly likely that that individual will be an employee. Typically self-employed people are genuinely responsible for how their business is run, will risk capital in their business and will have to meet any losses which arise.

The **number of paymasters** is also a determining factor. A typical employee has one paymaster – he is paid by his employer and no-one else. However, if a worker typically performs services for a number of different companies, he is more likely to be able to persuade the Revenue that he is self-employed.

Finally, the **ability to provide a substitute** has been something HMRC has looked at very closely when deciding whether a worker is employed or self-employed. An employee will have no freedom to send along a substitute in his or her place if, for whatever reason, they are unable to perform their duties. On the other hand, if a self-employed person has contracted to do a job and is either sick or double-booked, that self-employed person will have the freedom to provide a substitute to complete the job in his place.

This was a crucial factor in the case of *Hall v Lorimer*. In this case the Court, after much deliberation, concluded that a vision mixer was a self-employed person largely because on a handful of occasions, he had been able to provide a substitute to fulfil particular contracts.

When considering whether a worker is employed or self-employed, it is important to **take a "balance of probabilities approach"**. This means that no individual factor can be conclusive in its own right. It is necessary to look at the facts and circumstances of each case, apply the various criteria which we have just looked at, and, on balance, decide whether the worker is likely to be an employee or whether he is more likely to be self-employed.

HMRC have an online tool called the Employment Status Indicator which they use to determine a worker's employment status. It can also be used by taxpayers. Provided the information entered into the ESI is an accurate account of the work carried out for a particular engagement, the decision of the ESI can be relied on as HMRC's view of the status.

Guidance is also provided in two HMRC factsheets, which are reproduced in the Tolley's Yellow Tax Handbook. ES/FS1 ES/FS2

## 26.4 Implications

It is important to establish why we need to distinguish between whether a worker is employed or self-employed. An **employee will pay tax under** the employment income rules on earnings from his employment. A **self-employed trader will pay tax** on the profits of his trade. The rules for determining taxable earnings are different to those used to calculate trading profits.

One area where the rules are very different is concerning expenses. We know that it is very difficult for an employee to get a deduction for employment expenses. However, the expenses test for traders is far less stringent and self-employed traders can deduct much more by way of expenses than an employee. For this reason, many taxpayers would rather be treated as self-employed than as employees.

When earnings are paid to employees, the employer must account for tax at source under PAYE. Employees pay tax on their earnings as they go along. This is not the case for self-employed traders who will pay their tax on 31 January and 31 July under the Self Assessment regime. This can give self-employed traders a considerable cash flow advantage.

The distinction is very important for NIC purposes. Both **employees** and employers **pay Class 1 NIC on earnings**. Employers pay Class 1A National Insurance on benefits provided to their employees. Class 1 NIC is a considerable cost for employers, so for NIC purposes, it is very expensive for a company to take on an employee.

Class 1 NIC does not apply when payments are made to self-employed traders. **Self-employed individuals pay NIC under Class 2 and Class 4**. As you will see when you study the taxation of business income, it is considerably cheaper from an NIC perspective for an individual to be classed as a self-employed person.

**Employees** will typically have the right to join an **Occupational Pension Scheme** provided by their employer. **Self-employed persons** are not allowed to make payments into Company Pension Schemes. If they wish to make pension provision, they must do so via a **Personal Pension Scheme** or a **Stakeholder Scheme**. We shall look at pensions in a later chapter.

One major consolation for employees is that they do not have to worry about VAT. A **self-employed** trader will have to register with HMRC for **VAT** purposes once his turnover has exceeded a certain level. VAT regulations place a considerable administrative burden on self-employed taxpayers.

Finally, **employees** are **protected by the Employment Protection Acts**. For example, most employees will be entitled to sick pay, holiday pay, and maternity leave and will have the right not to be unfairly or wrongfully dismissed. On the other hand, self-employed persons are not covered by the Employment Protection legislation and will not have the same rights as employees.

For instance, if a company chooses to dispense with the services of a self-employed person – perhaps because they have found somebody else who will do the same job at a lower price - the **self-employed** trader will usually have **no legal redress**. He will simply have to accept it as part and parcel of the day to day business of a self-employed trader.

However, increasingly legislation gives rights and obligations to "workers", for example under the Working Time Directive and the National Minimum Wage Act 1998. Some individuals who are self-employed could have such statutory protection.

In summary the main differences are:

| *Employees* | *Self Employed* |
|---|---|
| Employment income | Trading income |
| Tough expenses test | Easier expenses test |
| PAYE | Self assessment |
| Class 1 NIC (expensive) | Class 2 and 4 NIC (cheaper) |
| Occupational pension | Personal pension |
| No VAT requirements | VAT registration |
| Employment law protection | Less legal protection |

## 26.5 Case Law

As the criteria to determine employed v self-employed have been largely built up over the years in the Courts, it is important that you are familiar with the leading tax cases in this area. In this session we shall look at three tax cases.

**Fall v Hitchen (1973)**

This case concerned a professional dancer. The dancer worked for a theatre company under a standard contract approved by Equity, which is the British Actors Union. Under the contract the dancer would attend rehearsals and performances over a period of around five to six months and either party could terminate the agreement by two weeks written notice.

The dancer worked specified hours and received a fixed salary paid at regular intervals. The dancer was provided with stage costumes and was permitted by the theatre company to seek work elsewhere in times when he was not needed.

The dancer argued that he was self-employed and should therefore be assessed on trading income. However the Courts rejected this claim and held that his contract was a contract of service. As such, he was treated as an **employee** and any income was **assessed as employment income.** Following *Fall v Hitchen*, HMRC assessed all actors engaged under standard Equity contracts as employees.

However, since 1993, it has been agreed that **actors in general should be treated as self-employed individuals** rather than employees engaged in a succession of employments. However on occasions where an actor is engaged in regular work, for a fixed salary for a particular employer, HMRC will regard that contract as a contract of service and charge any income under the employment income rules. This will be the case for actors who regularly appear on our screens in soap operas etc, as they perform services for a regular salary for one production company in a specified role.

**Market Investigations v Minister of Social Security (1969)**

This case involved a market researcher who worked as a part-time interviewer for a market research company. Her job was to ask pre-set questions devised by the market research company to members of the public. The market researcher had little or no control over what she did on a day to day basis – she was told what to do and how to do it. In addition, any equipment necessary for the job was provided by the market research company.

The case was brought to the Courts by the Department of Social Security who successfully argued that the worker should be treated as an **employee** for NIC purposes. As such, any earnings paid were subject to Class 1 primary and Class 1 secondary National Insurance Contributions.

Subsequent tax cases on the subject of employed versus self-employed have made reference to the Judge's summary in the *Market Investigations* case.

In his summing up, the Judge made reference to the use of the various criteria we have already looked at, such as the provision of equipment, the ability to hire a helper, and the degree of control and financial risk etc.

In this particular case, the Judge found that the market researcher was not in business on her own account and could not therefore be regarded as a self-employed individual.

**Hall v Lorimer (1993)**

Mr Lorimer was a vision mixer who worked for a number of different television companies. His work involved him undertaking a series of short-term contracts typically of one to two days each. Mr Lorimer worked for a number of different production companies, and over a three or four year period in the 1980s he received income from about 20 different companies.

Mr Lorimer's work was always undertaken on company premises using equipment provided by the studio company. This was largely due to the specialist nature of the work. Mr Lorimer issued the production company with an invoice after each job and was registered for VAT purposes. Mr Lorimer was responsible for making good his own losses and ran the risk of incurring bad debts. To guard against losses he had an insurance policy which covered him in the event of sickness. During the period in question, Mr Lorimer was unable to fulfil his obligations on a handful of contracts and in his place he provided a substitute worker.

HMRC argued that Mr Lorimer had a series of employments and hence should be taxed on employment income. They put particular emphasis on the fact that Mr Lorimer worked on studio premises using studio equipment.

However, both the High Court and the Court of Appeal agreed that Mr Lorimer was **self-employed**. The Courts commented that it was important to look at **all** the relevant criteria and to make a judgement based on an evaluation of all the factors rather than one or two in particular.

However, the Courts were particularly swayed by the fact that Mr Lorimer could, and indeed did, hire a helper to assist him in the performance of his duties and this ability to provide a substitute is not an option typically available to an employee.