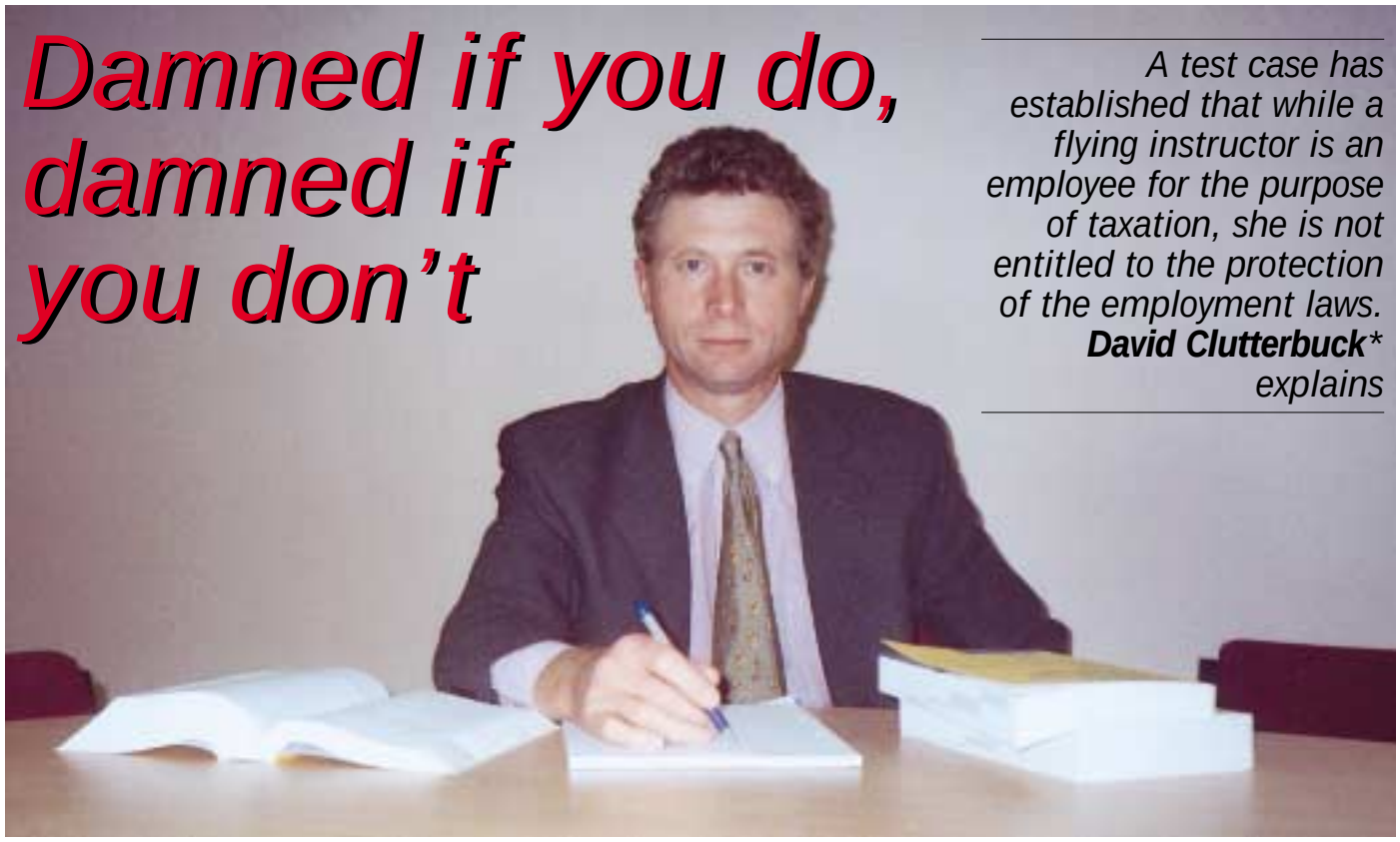
Damned if you do, damned if you don't



A test case has established that while a flying instructor is an employee for the purpose of taxation, she is not entitled to the protection of the employment laws. ***David Clutterbuck***** explains*

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The employment status of many flying instructors is far from clear. One government department may determine that you are an employee, whilst another may decide that you're self-employed – and the decision of one is not binding on the other, so you could end up being a two-time loser!

A flying instructor client of mine has been told by HM Revenue and Customs (HMRC) that she is an employee and subject to PAYE and National Insurance Contributions. However, an Employment Tribunal, which comes under the Dept of Trade and Industry, has ruled that she is not an employee and is not entitled to any employment rights. The fact that the tax authorities have dictated otherwise has no bearing on the matter.

Joined-up government? Dream on.

The problem for HMRC is there is no single definition providing a meaning of what constitutes employment or self employment in the tax legislation. The basic rules are laid down in the 1954 report of the Royal Commission on the Taxation of Profits and Income, with which few flying instructors will be familiar. The Commission determined that trading came under six headings, known as the 'Badges of Trade', of which five related to goods and their turnover – in other words, trading. Trading is now taxed under Schedule 5 of the Income Tax (Trading and Other Income Act) 2005 – "income tax is charged on the profits of a trade, profession or vocation". Therefore, someone who is self employed would be taxed under this section.

However, the Commission identified one further important criterion relevant to the status of the person carrying out a self employed trade, which was 'profit motive'. Further tests have evolved out of case law in order to determine what is employment and what is self employment. They are *Mutuality of Obligations, Control, Integration* and *Economic Reality*.

Where the first three of these factors are present, there is likely to be a *Contract of Service*, being employment. Where they do not exist together with *Economic Reality* – which constitutes profit motive, capital employed, own equipment, insurance, risk and reward – then there is likely to be a *Contract for Services*, being self employment.

HMRC issue a booklet, 'Employed or Self Employed', which sets out the various tests to determine status. It says:

If you can answer 'Yes' to all of the following questions, you are probably an employee.

- *Do you have to do the work yourself?*
- *Can someone tell you at any time what to do, where to carry out the work or when and how to do it?*
- *Do you work a set amount of hours?*
- *Can someone move you from task to task?*
- *Are you paid by the hour, week, or month?*
- *Can you get overtime pay or bonus payment?*

Effectively the questions are investigating the existence of Mutuality of Obligations, Control and Integration and in determining status these tests are seen as having collective importance as HMRC apply these tests to the working relationship as a whole rather than their individual importance.

With regard to self employment, the booklet says:

If you can answer 'Yes' to all of the following questions, it will usually mean you are self-employed.

- *Can you hire someone to do the work for you or engage helpers at your own expense?*
- *Do you risk your own money?*
- *Do you provide the main items of equipment you need to do your job, not just the small tools many employees provide for themselves?*
- *Do you agree to do a job for a fixed price regardless of how long the job may take?*
- *Can you decide what work to do, how and when to do the work and where to provide the services?*
- *Do you regularly work for a number of different people?*
- *Do you have to correct unsatisfactory work in your own time and at your own expense?*

Here the questions are investigating profit motive, capital employed, risk and reward.

'If an annual wage bill is £50,000, then NICs costs the employer a further £6,400'

As well as a self employed person having no employment rights – holiday pay, sick pay, redundancy etc – there is also a cost saving to an employer who does not have to pay Employers National Insurance Contributions. This currently runs at 12.8% on top of salary costs for an employee earning over £94.01 per week. So if an annual wage bill is £50,000 then NIC costs the employer a further £6,400. In the light of this, it is little wonder that HMRC defend their interpretation of what constitutes an employee with the utmost vigour!

The case in question concerns a client (the worker) for whom I had prepared accounts whose profession was "self-employed flying instructor". I had great reservations over this activity being self-employed as economic reality was largely not present, although in certain more minor circumstances it could be demonstrated. I advised the client that for tax purposes she would most likely be classified as an employee.

The client had at one time been an employee of the company (the engager) but had been made redundant and was later re-engaged as self employed, albeit with some different duties. After being re-engaged, her primary concern was that if she challenged her status with her 'employer' then her contract would be terminated, so she did not

do so. However, she was subsequently laid off and was unable to claim any employment rights, so she took her case to an Employment Tribunal (ET).

As part of this process she approached the HMRC Status Team to try to obtain a ruling on her status. Using the established tests, the following was deduced:

Mutuality of Obligations

- Work was carried out on a regular basis and at the same location.

Integration

- Flying lessons were booked and arranged through the engager.
- The engager's uniform was provided and required to be worn whilst on duty.
- Engager's payroll number used when payment for work made.
- Office space was provided by the engager, including the use of a telephone for which the worker did not reimburse the engager.
- She represented the engager, including appearing in promotional photographs.

Control

- She had to abide by procedures as laid down by the engager.
- Her student reports were subject to checks by the engager.
- There was constant monitoring by the engager of the service she provided.

Failure to Display Economic Reality

The engager provided the aircraft for the lessons which showed the engager's name.

- A substitute would be provided and paid for by the engager or the engager would arrange the cancellation of the lesson.
- Insurance was provided by the engager.
- She had no capital invested in the business.
- She carried little financial risk – only the cancellation of lessons.

The conclusion of the HMRC Executive was that she was an employee, and she was made aware that HMRC status opinions are only valid for tax and national insurance purposes.

Employment rights, on the other hand, are covered by the decision of an ET.

Her case went before an ET on the grounds of unfair dismissal. In order to be dismissed it is necessary to be an employee within the meaning of Section 230 of the Employment Rights Act 1996, which says broadly:

(1) 'Employee means an individual who has entered into or works under (or, where the employment has ceased, worked under) a contract of employment.

(2) Contract of employment means a contract of services or apprenticeship whether expressed or implied and (if it is expressed) where oral or in writing.'

> ***'Her primary concern was that if she challenged her status with her employer, then her contract would be terminated'***

An ET looks at the *substance of the contract* to examine if, for example, there are mutuality of obligations between the engager and worker. Thus if a worker is asked to carry out a service but can decline, or if mutual obligations have not been created by performance – the day to day working relationship – then a Tribunal is likely to conclude that a contract of service and hence employment does not exist.

This view needs to be contrasted against that of HMRC's, which in their official Employment Status Manual state: "The minimum obligations that are necessary for a contract of service (employment) are the obligation on the part of the worker to give personal service and the obligation on the part of the engager to pay the worker for that service. An employment contract will often also indicate that the engager will provide work for the duration of the contract during the agreed working hours."

Other test cases have provided the basis for another of the strongest indicators of self employment, which is the existence in a contract of the eligibility to provide a substitute. This is inconsistent with employment, as for a contract of service to exist there has to be an obligation on the employee to carry out the service personally.

So in the case of the flying instructor the Employment Tribunal considered the elements of employment/self employment and defined these as follows:

The following were not disputed:

- There were no written terms and conditions governing the relationship apart from a letter of appointment from the engager and a statement by them of the worker's status.
- She worked from the engager's premises and had the use of a desk, telephone and computer.
- She worked on the engager's aircraft and was not charged for the aircraft or fuel.
- She was expected to comply with the engager's airfield and operational policies.
- She was covered by the engager's insurance.
- She invoiced the engager each month for the number of flying hours completed.
- No deductions were made by the engager in respect of PAYE and NIC.
- The students initially approached the engager, who then arranged for the worker to teach them.
- She had no employee benefits, e.g. health insurance
- She submitted self employed accounts to the Inland Revenue

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The amount of control over the duties carried out by the worker was disputed:

The worker claimed that the engager controlled when she could arrange the lessons, and that she made herself available to work at all times and could not refuse to take lessons. The worker was unable to personally substitute another instructor in her place and was expected to perform all services personally.

The engager claimed they had no input into the number of students the worker took on, nor did the worker have to advise when she was available for work, although she did do this. They had no control over the days the students were scheduled to be taught. If she was unable to teach, then another instructor approved by the engager could take over. There was no obligation for the worker to accept any students neither were there any obligation for the engager to refer students to her.

The Tribunal considered the above and categorised the elements in favour of employment/self employment thus:

For employment

- The worker was required to wear a uniform.
- She did not provide her own tools.
- She was able to use a desk within respondent's business.
- She was not solely responsible for booking students.

For self employed

- She was paid gross without payroll

deductions and no Employers NIC was paid.
- She was paid on an invoice which included time charged for administration, for which an employee would not be able to charge, as that was incorporated into a normal day's pay.
- She was only paid if she worked.
- There was no obligation for her to attend the engager's premises at any particular time.
- She could take on other work, but she imposed a restriction on herself not to take up other work.
- The amount of work depended on what the engager offered, as evidenced by the variable invoices.
- She had no employee benefits.
- There was no obligation by the engager to offer work, neither was there any obligation to accept.
- She had invested in her own training, and her primary tool of trade was herself as a teacher.
- Cover if provided was by someone who was insured under the engager's policies.
- She did not challenge her status as self employed.

The Tribunal held that in the absence of any mutuality of obligation to provide work or to accept, coupled with the lack of any obvious or ostensible control, *(although lack of control is disputed)* then the worker was not an employee, but was a self employed contractor.

It is arguable that a wider view of the circumstances needs to be taken by Employment Tribunals, which has happened at Tribunals in the past. This wider view is concurrent with HMRC and Tax Practitioners method of looking at the facts standing back and weighing up the whole picture, and using those facts to examine the actual performance of the relationship. Had this been done then the conclusion of the ET may have been different as it didn't seem to grasp the fundamental reasons for the working relationship existing in the way that it did.

'I predict the revenue will pursue the 'employer' for PAYE and NIC, plus penalties and interest'

In this case the worker had previously been an employee of the company and had been laid off. When she recommenced working for them she was prepared to accept any conditions that the company laid down. Her engagement was to train students and as this was dependent on the number of bookings her work was ad hoc and therefore she worked flexible hours for flexible pay. Work was offered on a continuing basis dependent on student bookings

Due to the type of work carried out the sole focus on mutuality of obligations was flawed, and its importance was secondary to control, integration and economic reality of which some examples are:
- The worker reported to a line manager to authorise flights.
- The engager was required to maintain flight logs, records of flights, bookings, and rosters and for this the worker carried out this work in their offices at their desk using their equipment.
- The engager had control over and monitored the flights to ensure all procedures were carried out safely and correctly.
- The worker had to use the engager's call sign when communicating with Air Traffic Control.
- There was little or no risk, insurance was covered by the engager and the worker personally had no public liability insurance.
- There was little or no economic reality as any loss was confined to income from cancelled bookings, as she did not hire the aircraft, book the lessons to sell on at a profit.
- The worker had no capital invested in the business

So the client is now left with the unsatisfactory situation of HMRC considering her to be employed, and the Tribunal concluding she was self employed. This situation is also unsatisfactory for the engager, as I would predict from these circumstances that HMRC PAYE audit team would look to reclassify the worker and any others as an employee and seek PAYE and NIC plus penalties and interest. No doubt the engager could appeal citing the ET findings, but this could be a costly exercise particularly if it led to the higher courts.

In the interest of a 'joined up' approach, perhaps it's time to make the decision of each body which decides the case legally binding on every other subject to an appeals procedure

I recommend that all businesses and workers consider their status very carefully!

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