Low Incomes Tax Reform Group
A voice for the unrepresented

Work and Pensions Committee inquiry
Self-employment and the gig economy
Response from the Low Incomes Tax Reform Group (LITRG)

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1 Executive Summary and Summary of Recommendations

1.1 We welcome the opportunity to respond to this call for evidence. We do so as tax specialists with an interest and expertise in the tax and related welfare problems of those on low incomes, particularly the self-employed.

1.2 We are hugely concerned about the current structure of Universal Credit (UC) for the self-employed. If major changes are not made to the rules there is a serious risk that those who are already self-employed will be forced to give up their businesses in order to access adequate state support. Also, people are likely to be deterred from starting self-employment or forced into the hidden economy which is also worrying.

1.3 Two themes that run throughout this paper, particularly in relation to UC, are the significant compliance burdens that are being placed on the self-employed across UC and other tax and benefit systems and the fairness of the rules for the self-employed especially when compared to employees.

1.4 The current rules in UC, especially the Minimum Income Floor (MIF), take a very broad brush approach in an attempt to deal with a minority of people who may not be genuinely carrying on self-employment. However, at the same time as dealing with those people, the rules penalise those who have fluctuating incomes for a variety of reasons and those who have big business expenses that fall in one month rather than spread over the year leaving the self-employed claimant worse off than their employed counterpart.

1.5 This unfairness between the self-employed and employed is worsened by the impact of the surplus earnings and loss policy that is due to commence in April 2018. This policy was brought in to deal with people manipulating their income in order to maximise their UC award, however for the self-employed with normally fluctuating incomes it means they lose even more UC when compared to a similar earning employed person. This is particularly harsh when the MIF already acts as a disincentive to manipulate income. This policy is one of the most complex set of rules we have ever seen and we cannot see how it can work in practice.

1.6 At the same time, the monthly assessment periods, the way income is defined and calculated and the burdensome reporting requirements in UC fail to recognise the realities of self-employed business.

1.7 Alongside these problems in the UC system, the self-employed face difficulties across systems due to inconsistencies in definitions, different reporting requirements and measures of income. Thus the compliance burden for the self-employed is increased in both size and complexity. Low-income self-employed claimants are unlikely to be able to pay for advice to help them navigate these complexities.

1.8 While we are supportive of any attempts to help the low-income self-employed grow their businesses and to support those who are out of work who may be considering self-employment as a route into work, we are very concerned at the capacity and skills of Jobcentre plus staff to deliver this support. Moreover, unless the rules in UC are changed, this support will be wasted as people will not have sufficient time to establish and grow their business before being subject to the harsh and unfair MIF rules.

1.9 Finally, if Government policy is to encourage people, including the self-employed, to pay into pensions, the MIF must be changed so that it takes account of pension contributions. Not only does the current MIF structure discourage self-employed claimants from paying into a pension, it also worryingly creates disparity between employed and self-employed claimants.

Summary of recommendations

1.10 **Throughout this briefing we make a number of recommendations which are summarised as follows:**

- We recommend that a full review be carried out to identify all the different definitions of self-employment (the nature of self-employment, the income definitions, the reporting obligations and the commerciality tests) across tax, benefits and other areas of law. These rules should be harmonised across Government unless there is an exceptional reason why a difference is required.
- We strongly recommended in our response[1] to HMRC's Making Tax Digital (MTD) consultation that UC claimants should be exempt from the MTD requirements until there is alignment between the reporting requirements such that a single report will suffice for both HMRC and DWP, otherwise the burden on the low income self-employed will be even greater.
- We recommend that DWP should not go ahead with the proposed surplus earnings and loss rules (see Appendix A) but instead allow averaging of income for self-employed claimants who have fluctuating profits. A general anti-abuse provision could deal with those who purposely attempt to manipulate income, whether employed or self-employed.
- We recommend that the MIF is removed from UC altogether given that it represents a broad-brush approach that will negatively impact many self-employed who are trying to build a profitable business or who already have a business but happen to have fluctuating patterns of income.
- If the MIF is to be retained then the start-up period should be extended to at least two years, preferably three and the MIF should be calculated with reference to pension contributions to give parity with the employed. Some refinement to the MIF rules, along with averaging of incomes, could be done to reduce its impact, for example having a grace period of, say, three months in each calendar year to allow for one off expenses and having a facility for a claimant to request that the MIF be removed where circumstances warrant it.[2]

[1] http://www.litrg.org.uk/sites/default/files/files/161107-LITRG-response-MTD-business-tax-digital-age-FINAL.pdf

[2] For example, in the case of a farmer with a five year cycle, it may not be appropriate to apply the MIF if their accommodation is tied to their work and they are tied into a lease for land.

- It is crucial that work coaches have sufficient training and where possible practical experience in the small business world, particularly of typical businesses (such as farming and the entertainment profession) which are very susceptible to fluctuating earnings, so that they are better equipped to judge the viability of business activities. One model to deliver this would be to develop specialist work coaches with a small business background who can be supported by detailed guidance developed in conjunction with different industry sectors. Ideally, this support would be kept separate from the financial support issues relating to the UC claim.

2 About Us

2.1 The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.

2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

2.3 The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.

3 Introduction

3.1 *Importance of self-employment*

3.1.1 As the Committee have noted in their overview of the inquiry, nearly 5 million people are now self-employed and growth has accelerated in recent years. Although most self-employed people work full-time, it is part-time self-employment that has been growing faster in recent years. It is also noted that low pay in self-employment is much higher than in conventional work and self-employed workers can experience considerable variations in pay from month to month. These low-income self-employed workers cannot usually afford professional tax advice and have to try to understand the complex and ever-changing tax legislation with little or no assistance.

3.1.2 It is perhaps not surprising that part-time self-employment has grown so fast in recent years given that it offers far more flexibility than normal employment. It is therefore critical that the tax and welfare systems as well as other areas such as employment law are structured so as to support self-employment as a work option.

3.2 *Consistency across systems*

3.2.1 Since LITRG was set-up in 1998, one of the common themes that we have observed is a lack of consistency across the tax and welfare systems in terms of definitions and particular measures of income. This can lead to confusion and complexity for claimants and those who are administering the systems.

3.2.2 As the self-employed become an increasingly significant proportion of our labour market, and a sector which will only continue to expand, Government must be clear and consistent about exactly what constitutes self-employment so that there is no uncertainty as to who help and support is available to.

3.2.3 This is not the case at the moment. The self-employed have to interact with HMRC (for both tax, tax credits and shortly tax-free childcare), DWP (for benefits including UC in the future) and Local Authorities (for council tax reduction schemes and other local schemes). There are also wider areas that impact on the self-employed such as employment law or the income rules which dictate who is eligible for educational grants. All these departments have different rules and definitions.

3.2.4 It is unacceptable that rules have developed inconsistently so that a person can be classed as self-employed by one part of the Government for a particular purpose, but found not to be self-employed by another part of Government for another purpose. This can result in people falling between the gaps for support and leads to greater compliance burdens due to the differing evidence requirements.

3.2.5 With the emergence of the gig economy, even more people will require certainty about their employment status. Recent Court decisions[1] relating to the gig economy have found individuals to be 'workers' for employment law purposes (and so not self-employed for this purpose only), a status not currently recognised by most Government departments including DWP and HMRC for benefit purposes. This blurs the lines still further around status, and therefore eligibility for welfare support in particular.

3.2.6 Similarly, a self-employed person may have to calculate their income in one way for tax and then in a different way to access their local council tax reduction scheme which could mean that some expenses are allowed for tax that are not allowed by their Local Authority (or vice versa) and the period over which they have to calculate their income may be different.

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[1] See for example https://www.judiciary.gov.uk/wp-content/uploads/2016/10/aslam-and-farrar-v-uber-reasons-20161028.pdf

3.2.7 As if different definitions of self-employment, income and periods of income are not confusing enough, the reporting obligations across the tax and welfare systems are also different. This can place a significant administrative burden on the self-employed especially when the figures that need to be provided are not the same.

3.2.8 Recently, we were contacted via our website by a self-employed person who had set up a business with the support of a Jobcentre after being on benefits for some time. They were directed to the New Enterprise Allowance (NEA) and then told to claim Working Tax Credit (WTC). However their WTC claim was turned down by HMRC, on the basis that the self-employment was not commercial, not undertaken with a view to realising a profit and not regular and organised. The person involved found this distressing and confusing given that one department had helped her set up the self-employment only to be told by the other that it did not qualify for support despite the fact she was carrying out in excess of 30 hours work a week towards the business.

3.2.9 Undoubtedly the NEA has helped people into self-employment, however we have found that mentors do not necessarily know the detailed requirements of HMRC for claiming tax credits, especially since HMRC have been applying more stringent rules surrounding commerciality. Similar issues will occur with UC and this should be examined in depth so that such commercial tests are realistic when measuring what is reasonable across the broad spectrum of self-employment.

3.2.10 We would also like to draw attention to the new allowance for trading income[1] due to be introduced for tax purposes from April 2017. Where the allowances cover all of an individual's relevant trading income (before expenses) then they will no longer have to declare or pay tax on this income. Those with higher amounts of income will have the choice, when calculating their taxable profits, of deducting the allowance from their receipts, instead of deducting the actual allowable expenses.

3.2.11 While we welcome the introduction of this new allowance as we consider it will be helpful for low-earners who may be discouraged from earning a small amount of additional income because of their tax obligations or who are in-between 'hobby-trading' and starting a new self-employed business. It will provide a lee-way between when you need to report relatively small amounts of income to HMRC and when you do not. However we are concerned about the further complexity and potential confusion this creates as it seems the trading income/expenses will need to be reported to DWP for UC purposes. This is likely to cause confusion for some self-employed claimants who are being told by HMRC they do not need to declare the small trading income but are told the opposite by DWP.

3.2.12 We recommend that a full review be carried out to identify all the different definitions of self-employment (the nature of self-employment, the income definitions, the reporting

[1] https://www.gov.uk/government/publications/income-tax-new-tax-allowance-for-property-and-trading-income/income-tax-new-tax-allowance-for-property-and-trading-income

obligations and the commerciality tests). These rules should be harmonised across Government unless there is an exceptional reason why a difference is required.

3.2.13 When designing new systems, the self-employed should be at the forefront of the design. In our experience, they are often identified as a concern and put to one side and then considered towards the end of any design work meaning by then that the system created does not easily fit with the nature of self-employment. This is particularly true for UC and to some extent tax-free childcare, launching in 2017.

3.3 *Digital changes*

3.3.1 In our previous evidence to the Committee in response to the inquiry into the future of Jobcentre plus, we outlined our concerns about the digital-by-default approach.[1] UC has been designed to be digital-by-default, but it is important that care is taken to ensure that people are not excluded from claiming benefits, nor from complying with DWP monthly reporting requirements, where they struggle to do so digitally.[2]

3.3.2 This is particularly true for the self-employed who, under the current rules, will have to report their income monthly online. HMRC recently consulted on their plans for making tax digital under which – by 2020 – most businesses, self-employed people and landlords with annual turnover above £10,000 will have to keep track of their tax affairs digitally and to record transactions digitally as close as possible to real time. We were disappointed that the main HMRC consultation documents did not consider the links with UC. We strongly recommended in our response[3] that UC claimants be exempt from the MTD requirements until there is alignment between the reporting requirements such that a single report will suffice for both HMRC and DWP, otherwise the burden on the low-income self-employed will be even greater.

4 Universal Credit

4.1 *General comments*

4.1.1 We are wholly supportive of the principles behind UC to make work pay and to merge six benefits into one in order to make administration easier for claimants as well as DWP. However, since the Bill that became the Welfare Reform Act 2012 was introduced in

[1] http://www.litrg.org.uk/sites/default/files/files/160609-LITRG-evidence-WP-select-committee-FINAL.pdf

[2] LITRG's most recent work on digital matters can be read in full in our report "Digital services for taxpayers – effectiveness and engagement", see: http://www.litrg.org.uk/latest-news/reports/161129-digital-services-taxpayers-%E2%80%93-effectiveness-and-engagement

[3] http://www.litrg.org.uk/sites/default/files/files/161107-LITRG-response-MTD-business-tax-digital-age-FINAL.pdf

Parliament, we have had serious concerns about the structure of UC for the self-employed and the support that will be offered as a result.

4.1.2 This could lead to people either not starting or giving up self-employment even in cases where that self-employment is as profitable as a full-time minimum wage job. The rules at present also create a disparity between the employed and self-employed and this needs to be addressed urgently.

4.1.3 We are also concerned that unrealistic expectations are placed upon those moving from long-term unemployment into self-employment as to the period of time necessary to create a viable business. This can take several years, especially in areas of the country where demand for goods or services is weak due to general economic conditions. The current rules for measuring commerciality are very blunt instruments which do not recognise such regional differences.

4.2 ***Current problems with UC for the self-employed***

4.2.1 We summarise below the issues with the UC system as it is currently designed for the self-employed, before considering some of these issues in more detail:

- **Lack of alignment with the tax system –** For UC purposes, DWP operate a crude cash basis for calculating monthly profits from self-employment, however these rules are different to the ones used by HMRC for the cash-accounting basis. Many low-income self-employed people still use the accruals basis of accounting however this cannot be used for UC and they must use the UC cash basis rules instead. This is particularly important for certain groups such as farmers who may be unable to account on a cash basis. In addition, DWP are able to make their own decision about whether someone is carrying on a 'trade, profession or vocation' which could lead to a different conclusion than HMRC despite the same test being applied.
- **Reporting obligations –** UC requires self-employed claimants to report their earnings within two weeks of the end of each monthly assessment period. This is a potentially time-consuming administrative burden which is likely to be greater if the person is not using the cash basis for HMRC purposes and if they do not have access to digital channels.
- **Measurement of income –** UC is currently designed around monthly assessment periods. This works well for employed claimants but not for most self-employed claimants as it cannot deal with those who have uneven earnings throughout the year, those who have big expenses falling in a particular month and periods where losses are made.
- **Loss relief –** As the rules stand pre-April 2018, there is no recognition in UC for self-employed losses as there is in the current tax credit system.

- **Surplus earnings policy –** From April 2018[1] UC rules will be amended to introduce a surplus earnings and loss policy in order to stop claimants manipulating their income to increase their UC. This will potentially allow losses to be carried forward from one month to the next, but due to the MIF (see below) this is unlikely to help many people impacted by the rigid monthly assessment periods. We discuss the proposed rules in Appendix A.
- **Minimum income floor –** Perhaps one of the most concerning parts of UC for the self-employed, under which for any month where the claimant's profits fall below the MIF (for most this will be set at 35 hours x national minimum wage (NMW)),[2] the claimant's UC award is assessed as if he/she had profits at least equal to the MIF. This fall could be due to a large expense in that particular month (such as an insurance premium or a self-assessment tax bill).
- **Start-up period –** Currently, newly self-employed claimants[3] receive a 12-month start-up period where the MIF does not apply. We agree that the concept of a start-up period is crucial for those starting out in self-employment, however we do not think that the current start-up period is long enough to allow businesses to reach their initial potential. Research by the RSA, referenced by Citizens Advice, shows that on average it will take three years for a self-employed person to be earning the equivalent of the NMW from their business.[4]
- **Traps for the unwary** – Increasingly, the UC regulations have been drafted in a way which departs from the tax system's approach to the same situation, or UC regulations have not been amended to recognise a change in the way that the tax system addresses a particular issue. It is unlikely that the average small trader will recognise such subtleties and will gain an understanding of the "rules" from either HMRC or the DWP without realising that the two Departments treat common situations differently. This could lead to "mistakes" in reporting.

4.3 *Measurement of income and loss relief*

Measurement of income

4.3.1 As we noted above, one of the features of UC is the monthly assessment period. For the self-employed, they must report their income for the monthly assessment period which is calculated as follows:

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[1] Initially these rules were to apply from 6 April 2016 in UC digital areas, however they have been delayed to April 2018.

[2] It was announced in the Autumn Statement 2015 that the individual threshold in the MIF would be uprated in line with the national living wage (NLW). The NLW is the single hourly rate of the NMW for those aged 25 and over and is currently £7.20 an hour.

[3] Existing self-employed claimants entering UC will not have a start-up period. We understand that those transferring from tax credits to UC may get a 6 month grace period before the MIF applies.

[4] Citizens Advice report – Going Solo (2015), Page 14 referring to research by the RSA: https://www.citizensadvice.org.uk/Global/CitizensAdvice/Work%20Publications/GoingSolo.pdf

Gross profit --- Income tax, National Insurance and pension contributions = earnings

Gross profits are defined as 'actual receipts' in that assessment period minus 'permitted expenses' in that assessment period.

4.3.2 For a self-employed earner with a steady amount of receipts and corresponding expenses, the result will be similar to an employed person with similarly steady income. However, in our experience that is rarely the case for the self-employed. The rigidity of the monthly assessment periods means that the current system cannot deal with:

- Those who have uneven earnings throughout the year – for example farmers.
- Those who have big expenses – such as an annual insurance premium falling in a particular month. Although this would be an allowable deduction, the impact of the MIF could mean in reality no relief is given for the expense.
- Periods in which losses are made – either in the early years of the business or due to an unexpected change (such as the loss of a major customer or contract or a bad debt).

4.3.3 Some of these claimants would, if viewed over an annual period, make more than the NMW, but due to their income/expense patterns can be unfairly penalised by the rigidity of the monthly assessment period.

Example 1

Fiona is a single parent with three children and runs a self-employed business with fluctuating profits across the year. Gregory is a single parent with three children who works 35 hours a week and earns £7.20 an hour as an employee.

Over 12 months, from April 2016 to March 2017 Fiona's self-employed income for UC purposes is £12,077 and Gregory's employment income for UC purposes is also £12,077.

Fiona will receive a total of £5,333.43 in UC payments over those 12 months while Gregory will receive £7,944.96

Gregory receives £2,611.53 more UC than Fiona because of the variable pattern of earnings that Fiona has in her business even though over the year both earn the same amount.

If the proposed surplus earnings rules applied to Fiona, she would receive £455 less UC than the figures above show. She would then be even worse off when compared to Gregory by £3066.53. See Appendix A for a discussion of surplus earnings.

(See Appendix B for the detailed calculation)

4.3.4 We recommend that these rules are replaced with averaging rules for those with fluctuating incomes, which would allow averaging of income over a period up to one year. See Appendix A for further discussion of the proposed surplus earnings and loss rules.

Loss relief

4.3.5 Under the current rules there is no facility to deal with self-employed losses in monthly assessment periods. In any month that a loss is made outside of the 12 month start-up period, the MIF will apply. Within a 12 month start-up period, the person will be treated as earning nil and will receive maximum UC in that month. See Appendix A for discussion of the surplus earnings and loss rules which will be introduced in April 2018.

4.4 ***Minimum Income Floor***

4.4.1 Self-employed claimants in the 'all work requirements' group of UC, who have been found to be 'gainfully self-employed',[1] will be subject to the MIF for any month where their income from self-employment falls below the MIF threshold. The MIF threshold is equal to the NMW for the claimant's age group multiplied by their expected number of hours each week. For most people, the expected number of hours will be 35 hours a week, although it may be less for example if the claimant has caring responsibilities, is responsible for a young child, or has a physical or mental impairment. This gross MIF is then adjusted by deducting a notional amount for tax and National Insurance – these deductions are calculated based on what an employed person earning that amount would pay in tax and National Insurance as opposed to what the self-employed person actually pays.

4.4.2 While an employed person has a right to receive the correct rate of NMW and benefit from statutory increases in the rate, a comparable self-employed person may not be able to increase their profits in-line with rises in NMW rates for various reasons, but especially during periods of economic uncertainty, unexpected ill-health or caring responsibilities. Tying the MIF to the NMW removes discretion in the rate of MIF which can be applied and is potentially more detrimental to a self-employed worker than the equivalent employed worker who can legally rely on the NMW.

4.4.3 The NMW has increased significantly following the introduction from 1 April 2016 of the National Living Wage (NLW) rate. This is the rate of the NMW paid to those aged 25 and over and currently is £7.20 and is expected to rise to £7.50 per hour from April 2017. This means the MIF has increased, requiring the self-employed to earn even more and if they cannot, they will receive even less UC because they will be treated as earning the now higher MIF.

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[1] Gainful self-employment means that the self-employment is a trade, profession or vocation should be the main occupation. It must also be organised, developed, regular, and carried out in expectation of profit. See https://www.gov.uk/government/publications/universal-credit-and-self-employment-quick-guide/universal-credit-and-self-employment-quick-guide#what-does-it-mean-to-be-gainfully-self-employed

4.4.4 During the many debates as the UC legislation was passing through Parliament, as well as in later debate, the Government stated that the MIF was needed to stop people staying at a very low level of activity and receiving state support – it was introduced to 'incentivise individuals to increase their earnings from their self-employment' and to 'address a loop-hole in the tax credits system whereby individuals can report little or zero income but still receive full financial support, which is neither a desirable or sustainable situation to maintain'.[1] The other element of the MIF is that it is designed to ensure that the self-employed have similar requirements to employed claimants (who are subject to conditionality if they are not earning above their required level).

4.4.5 We do not agree that there is a loophole in tax credits as described by Lord Freud – the legislation in tax credits has always allowed HMRC to ensure they are only paying tax credits to those self-employed people whose hours are for payment or in expectation of payment and this test was further strengthened from April 2015 so claimants are now required to show they are trading on a commercial basis, in a regular and organised way with a view to realising a profit. Historically, in the early years of tax credits, HMRC operated a pay now and check later approach which allowed some claimants essentially to claim tax credits while hobby trading. Since the new test has been applied from April 2015, many of these claims have been stopped by HMRC and therefore these people would not move to the UC system.

4.4.6 We agree there should be equality between the employed and self-employed, as far as is possible given the major differences between the two groups. We also understand some of the concerns about people who are more likely classed as 'hobby traders' claiming state support for long periods of time. However, we do not believe that a broad brush approach with a tool like the MIF is the right way to address this perceived problem.

4.4.7 The MIF currently only applies to those who are deemed to be 'gainfully self-employed' meaning they have satisfied DWP that this is their main employment and they are carrying it out on a regular and organised basis with a view to achieving a profit. As part of this determination, DWP will look at the marketing activity of the business, their business plan, plans for advertising, copies of adverts, diary appointments, websites and other materials, the volume of work that is in the pipeline, accounts, whether the person is progressing their business. In other words, the MIF will only apply to those who are actually trading in a way that the Government wants and who are most definitely not hobby traders or those who were taking advantage of the 'loophole' in the tax credits system.

4.4.8 Another unfairness in the MIF is that it applies independently each month without considering what has gone on before or what may happen in the future. This means that it negatively impacts on those who have fluctuating earnings, this could be due to the seasonal nature of their business or it could be due to when customers decide to pay.[2] Even when

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[1] http://www.publications.parliament.uk/pa/ld201516/ldhansrd/text/151214-0003.htm

[2] For example you could have a self-employed painter and decorator or builder, who could be working steadily but have a month when no-one pays at all and other months when they are paid for last month and this month's work.

viewed over a longer period, where earnings are at least the equivalent of NMW, the MIF will still be applied. For example, due to the pattern of earnings a claimant could have a large insurance premium to pay in one month which triggers the MIF and causes them to lose UC as the following example shows. This is surely not an intended consequence of the MIF.

Example 2 – Alyssa

This example shows a self-employed claimant who runs a wedding photography business. Alyssa has a large insurance premium to pay which is £1,200 for the year (covering her public liability, indemnity and equipment insurance). Due to her previous credit rating she is unable to take advantage of a monthly payment plan.

Alyssa's UC for a 12 month period will be £12,769.89. If she was able to pay her premium monthly instead, she would receive nearly £600 more in UC over the year.

This is because when she pays her premium of £1,200 in month 5, her income in that month is reduced to £100. The MIF then applies and she is treated as earning £1,006.49 that month and so most of the expense of the premium is in effect disallowed for UC.

The proposed surplus earnings rules from April 2018 will not help someone in Alyssa's situation and this shows that the MIF impacts on people who have large expenses to pay even though over a year they are earning well above the MIF.

See Appendix B for more detailed calculations.

4.4.9 In evidence before your Committee in 2012 Lord Freud, in response to examples we submitted in evidence to your inquiry into the implementation of UC, said that he would make sure that there is parity between the self-employed and employed and 'that to the extent that there is not, we will sort that out. That is a technical issue that we will sort'.[1] Originally, the MIF was to be calculated using a gross figure taking no account of tax and National Insurance. We welcomed the decision to calculate the MIF taking some account of tax and National Insurance, albeit a notional figure as this removed some of the disparity between the employed and self-employed that we drew attention to during that inquiry.

4.4.10 As this paper makes clear, the lack of parity between the self-employed and employed (as demonstrated by *Example 1* above), which is more than a technical issue, was not sorted out but remains an urgent task for Lord Freud's successor.

4.4.11 There is also disparity for the low-income self-employed who want to make pension contributions, as shown by the following example:

[1] http://www.publications.parliament.uk/pa/cm201213/cmselect/cmworpen/576/120917.htm

Example 3 – Aaron and Derek

Aaron is a self-employed builder – his self-employed income for January 2017 is £1,092. His notional tax and National Insurance will be £85.51.

Derek works in a call centre for 35 hours a week earning the NLW (currently £7.20). His monthly income is also £1,092 and he has deductions of tax and National Insurance of £85.51 in that assessment period.

Aaron and Derek will both receive the same amount of UC in January 2017, assuming their circumstances are both the same.

In February 2017, Aaron and Derek both decide to pay £75 a month into a private pension. Derek will have his UC calculated on his new net income of £931.49 (£1,092 gross less tax and NI of £85.51 and pension contributions £75) whereas Aaron will have his UC calculated on £1,006.49. This is because Aaron's actual income of £931.49 is lower than the MIF of £1,006.49.

This means that Derek will receive nearly £50 a month more UC than Aaron despite them having the same earnings each month and making the same pension contributions. Aaron is therefore not given any recognition for his pension contributions.

4.4.12 We recommend that the MIF is removed from UC altogether given that it represents a broad-brush approach that will negatively impact many self-employed who are trying to build a profitable business or who already have a business but happen to have fluctuating patterns of income/expenditure.

4.4.13 If the MIF is to be retained then the start-up period should be extended to at least two years, preferably three and the MIF should be calculated after deduction pension contributions to give parity with the employed. Some refinement to the MIF rules, along with averaging of incomes, could be done to reduce its impact, for example having a grace period of say three months in each calendar year to allow for one off expenses and having a facility for a claimant to request that the MIF be removed where circumstances warranted it.[1]

[1] For example, in the case of a farmer with a five year cycle, it may not be appropriate to apply the MIF if their accommodation is tied to their work and they are tied into a lease for land.

5 Tax Credits and other benefits

5.1 *Tax credits and self-employment*

5.1.1 The tax credits system has faced much criticism due to the level of overpayments and the volume of error and fraud in the system. However, for those who are self-employed, the mechanism by which income is calculated and reported works reasonably well.

5.1.2 Tax credits are based on a tax year and therefore align to the tax system. For the self-employed this means that in the majority of cases the same figure that is reported to HMRC for tax purposes as taxable profit is also reported to HMRC for tax credit purposes. No additional calculation is required.

5.1.3 The period of reporting is also aligned with the tax system so that by 31 July following the end of the tax year an estimated income is required to be reported (unless the actual figure is known) with the actual figure to be confirmed by the following 31 January (the self-assessment deadline). If a fall in income is experienced during the year, subject to the £2,500 disregard for falls in income, tax credits can be adjusted to be based on this new estimated amount.

5.1.4 HMRC are able to check claims when they are initially made to ensure only those who are genuinely self-employed (as opposed to hobby trading) receive the WTC.

5.1.5 Of course the system is not perfect and because it is based on an annual system it means that payments are spread evenly over the year often based on previous year income and so they do not always respond to changing income. However, it does create a level of certainty for the self-employed that if their annual income is £X (give or take £2,500 in either direction) their payments will be correct. There is always the risk of overpayment in tax credits, and some self-employed claimants do find it difficult to estimate their income when they start-up their business, but by and large it seems manageable and certainly deals with businesses who have significant fluctuations across a year in terms of income and expenses.

5.2 *Other benefits*

5.2.1 Our experience of other benefits is less extensive, but we do often get enquiries from self-employed claimants who are struggling with other DWP benefits, particularly housing benefit and Local Authority benefits such as council tax reduction schemes.

5.2.2 More and more Local Authorities seem to be introducing the MIF into their assessments for council tax reduction schemes in an attempt to mirror the UC rules. Housing benefit rules differ from both tax credits and the tax system meaning that claimants have to report different figures and it can be difficult to follow the averaging rules in housing benefit for some claimants where estimates are required (leading to reports in some cases that the Local Authority seek to recover this money where the person had higher income than they estimated when working out their average income as per the housing benefit rules).

5.2.3 It would be unfortunate if MIF systems introduced by Local Authorities were classed as a success in reducing inappropriate claims to support, when the reality was that the complexity of reporting acted as a barrier to those otherwise entitled to support.

5.2.4 There is a great deal of variation in what is counted as income and what is allowed as an expense between the tax system, tax credits, housing benefit, council tax reduction schemes and DWP benefits. This leads to a great deal of confusion for claimants, particular around items of capital expenditure.

6 Support for the self-employed – Jobcentre plus

6.1 Eventually, the majority of low-income self-employed people who qualify for some state support will be within the UC regime (as opposed to tax credits, housing benefit and other legacy benefits).

6.2 Up until that point, most self-employed people will have been used to the tax credits system which did not involve any interaction, beyond that required for claiming and maintaining the claim, with HMRC. There is no additional support offered by HMRC to tax credit claimants once they are in self-employment, although some do come to tax credits via Jobcentre plus with the support of the New Enterprise Allowance.

6.3 In March 2016, we welcomed[1] the Government's Budget announcement of mentoring support for low-earning self-employed workers to help them grow their businesses and the extension of the existing mentoring under NEA to UC claimants.

6.4 While we are supportive of any attempts to help low-income self-employed grow their businesses and to support those who are out of work who may be considering self-employment as a route into work, we have two major concerns – the first is the capacity and skills of Jobcentre plus staff to deliver this support and secondly the risk that the lack of financial support from UC will mean the support is wasted as the current design will force people away from self-employment if they cannot quickly make a profit or if their business is one of the many businesses that has fluctuating earnings.

6.5 Jobcentre plus staff will be tasked with conducting gateway interviews with UC self-employed claimants where they will need to first establish if the person is carrying on a 'trade, profession or vocation' and then decide whether the person is in 'gainful self-employment' under UC rules.[2] This includes determining if the self-employment is their main employment and if it is organised, developed, regular and carried out in expectation of profit.

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[1] https://www.tax.org.uk/media-centre/press-releases/litrg-press-release-low-earning-self-employed-need-financial-support

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/565510/admh4.pdf

6.6 Application of these tests requires a great deal of knowledge on the part of the work coach, not only in terms of understanding what it is the UC claimant is doing day-to-day in their business but also understanding the wider industry they are part of (so that they can understand what is normal with regards to fluctuations) and any regional issues which may impact the growth of the business. In order to then provide support to help the person grow their business, they will also need to understand elements of business including marketing, financial planning, business plans, sources of funding, differences between capital and revenue, elements of tax and accountancy, legal and employment law issues.

6.7 It is crucial that work coaches have sufficient training and where possible practical experience in the small business world, particularly of typical businesses (such as farming and the entertainment profession) which are very susceptible to fluctuating earnings so that they are better equipped to judge the viability of business activities. One model to deliver this would be to develop specialist work coaches with a small business background who can be supported by detailed guidance developed in conjunction with different industry sectors. Ideally, this support would be kept separate from the financial support issues relating to the UC claim.

7 Pensions and the self-employed

7.1 Other organisations are better placed to comment on how the self-employed can best be encouraged and supported to save for retirement and whether they should be required to enrol for a pension.

7.2 However, if Government policy is to encourage people, including the self-employed, to make provision for retirement, UC should not work against this as it currently does. The benefits system generally allows pension contributions[1] to be deducted from income and this acts as an incentive to pay regularly into a pension. The UC rules allow this for both employed and self-employed claimants, however the lowest income self-employed may be subject to the MIF and if so will receive no recognition for pension contributions they make that takes them below this MIF level.

7.3 We would also like to draw attention to the proposed changes to the self-employed National Insurance system that may mean that some low-earners may no longer contribute towards their state pension, for example if they earn below the class 4 threshold and cannot afford to make class 3 contributions. Therefore any support should take into account that these low earners may have no/little pension at all.

LITRG
16 January 2017

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[1] To a registered/approved pension scheme. Some benefits allow only a 50% deduction for pension contributions, however tax credits and UC allow 100% deduction.

APPENDIX A – SURPLUS EARNINGS RULES EFFECTIVE FROM APRIL 2018

Surplus earnings

In 2014, DWP introduced surplus earnings regulations in order to deal with two potential risks that they had identified in the UC system. Firstly, the risk that employers and paid workers will realise that certain payment patterns can work in such a way as to maximise UC entitlement and deliberately manipulate earnings to take advantage of this; secondly, that workers with variable earnings patterns are either unduly penalised or unfairly rewarded by receiving less/more UC than they would if they earned the same amount each month.[1]

Under the regulations, large payments of earnings can be taken into account for more than one assessment period for both the employed and self-employed. This applies where a claimant receives a payment of earnings that is sufficient to reduce their entitlement to nil but then regains entitlement to UC within six assessment periods of the last day of their previous entitlement. At the same time, the self-employed can have losses in the previous 11 assessment periods taken into account to reduce their income.

These rules are horrendously and unnecessarily complex and we are concerned about how difficult they will be to administer for DWP, but more importantly how claimants will understand them. Our response to the SSAC consultation that was carried out in relation to these regulations sets out in more detail our concerns for both the employed and self-employed but in summary, for the self-employed, these are:

- The difficulties with administering the policy from a DWP perspective.
- The complexity of the rules – we doubt that DWP will be able to explain it well enough to claimants so they understand the need to budget in any period during which they are outside of UC. For the self-employed, this means if they have a good month, they will need to budget that extra income for up to six months in case of a fall in income.
- The fine detail of the policy has been fixed to make it easier for DWP to administer rather than ensuring fairness for all claimants – this means that the rules for calculating the surplus amounts in any intervening periods off UC take into account the person's actual income but not any changes or circumstances. Thus, for example, if they have another child or increased childcare costs in the period they are off UC, this will not be taken account of when calculating the surplus, meaning their surplus will be artificially high.

[1] See explanatory notes accompanying the Social Security Advisory Committee (SSAC) consultation on these regulations: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364573/uc-earnings-Explanatory_Memorandum.pdf

The impact of the policy will be greatest on the self-employed who do not have losses. The DWP used examples in the explanatory notes to the SSAC consultation to justify the policy, however if those examples were worked through with self-employed people instead of employed a different set of results would be seen. The self-employed person with similar spikes in income obtains no advantage from ‘manipulating’ income in the first place and in fact receives £200 less UC in total than their employed counterpart due to the MIF. Secondly, they would lose a further £600 of UC entitlement once the surplus earnings policy is applied. We have illustrated this in example 2 of Appendix B. This is due to the interaction with the surplus earnings policy and the MIF. Again, this means the self-employed are worse off by comparison with a similarly earning employed person.

While we welcome recognition of losses for the self-employed, the proposed solution is incredibly complex and difficult to understand. Again, the interaction between the MIF and this policy means losses are only recognised in so far as they reduce income to the level of the MIF. Also, pension contributions have been disallowed in calculating losses, thus creating further disparity between the self-employed and employed and a disincentive for self-employed workers to save for retirement.

The surplus earnings and loss rules were due to come into force in April 2016. This has now been delayed to April 2018. We urge DWP to use this time to reconsider the policy and explore alternatives.

We recommend that DWP should not go ahead with the proposed surplus earnings and loss rules but instead allow averaging of income for self-employed claimants who have fluctuating profits. A general anti-abuse provision could deal with those who purposely attempt to manipulate income, whether employed or self-employed. The UC Regulations[1] already allow for averaging for employed claimants when looking at their monthly earnings for conditionality purposes. In those cases where a person’s earned income fluctuates, or is likely to fluctuate, earnings are calculated over one cycle (if there is an identifiable cycle) or where there is no identifiable cycle, over three months or other such period as may be determined to allow an accurate figure.

While the detail of how this would work would need some further thought, for example to look at how often this should be re-assessed and how to deal with potential over/underpayment situations, it would mean that in *Example 1* above, Fiona could average her income over the 12 month period and she would be treated as earning £1,006 in each assessment period. Thus her UC payments would remain the same and more importantly she would end up receiving the same amount of UC as Gregory over the 12 month period.

Allowing averaging would remove the need for complicated loss rules and would be far easier to administer and explain to claimants. In response to DWP concerns around manipulation of income, we think a simple general anti-abuse provision that would allow

[1] Universal Credit Regulations 2013, Reg 90 (SI 376/2013)

them to also average income in situations where people are seeking to manipulate earnings patterns would give sufficient protection for both employed and self-employed claimants and should be easy to administer given the use of Real Time Earnings data[1] for the employed.

[1] Real time earnings data is information received by DWP from HMRC. HMRC obtain the information from employers and pension providers through the real time information (RTI) system which requires employers to report to HMRC on or before each payment is made to an employee.

APPENDIX B – Example calculations

Example 1 – Fiona and Gregory[1]

The following table shows Fiona's actual self-employed earnings for each monthly assessment period, her treated earnings and the amount of UC received. It also shows Gregory's net earnings from self-employment and his monthly UC figure.

The figures in red show Fiona's UC if the proposed surplus earnings rules apply to her (see Appendix A for further discussion about the surplus earnings and loss rules).

Month	Fiona's actual self-employed earnings[2] £	Fiona's income for UC calculation[3] £	Fiona's UC payment[4] £	Gregory's net employment earnings[5] £	Gregory's UC payment[6] £
April 16	3,000	3,000	0	1,006.49	662.08
May 16	1,500	1,500 (2174.94)	341.29 (0)	1,006.49	662.08
June 16	2,000	2,000	16.29	1,006.49	662.08
July 16	2,500	2,500	0	1,006.49	662.08
August 16	1,500	1,500 (1674.94)	341.29 (227.58)	1,006.49	662.08
September 16	200	1,006.49	662.08	1,006.49	662.08
October 16	300	1,006.49	662.08	1,006.49	662.08
November 16	500	1,006.49	662.08	1,006.49	662.08
December 16	Nil	1,006.49	662.08	1,006.49	662.08
January 17	Nil	1,006.49	662.08	1,006.49	662.08
February 17	577	1,006.49	662.08	1,006.49	662.08
March 17	Nil	1,006.49	662.08	1,006.49	404.02
TOTAL	12,077	17,545.43	5,333.43 (4878.43)	12,077.88	7,944.96

[1] Assumptions used in the example – Fiona is out of her 12 month start-up period and has no special circumstances that reduce the number of hours she is required to work. Children are all over the age of 13. Fiona's business pays out the majority of expenses between September and March.

[2] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions.

[3] Applying a MIF of £1,006.49 which is 35 hours x £7.20 less notional tax and National Insurance of £85.51 each month.

[4] Calculated with standard rate (£317.82) and 3 child elements (£277.08+£231.67+£231.67) making a maximum UC amount of £1,058.24. The work allowance (£397) is deducted from the earned income for that month and the taper of 65% is applied to the resulting figure. This is then deducted from the maximum amount figure to determine the monthly entitlement for UC.

[5] Calculated as 35 x £7.20 (NLW for his age) x 52/12 = £1,092 minus tax, NI of £85.51. We have assumed no pension contributions have been made by either Fiona or Gregory.

[6] Calculated in the same way as Fiona.

Example 2

This is based on the example used by the DWP in their explanatory memorandum[1] to the Social Security Advisory Committee during the consultation on the surplus earnings and losses proposal.

The example DWP used showed Paul and Barry, two employees who over a 12 month period, earn the same amount. It demonstrated 'the potential for unfairness and possible incentive for households to manipulate their patterns of pay to increase their UC entitlement'. By altering his pattern of payments so that he received just two payments over the year, Paul gained an extra £5,259 in UC compared to Barry over the 12 month period. The surplus earnings and losses policy was designed to combat this potential manipulation.

However, if the example was changed slightly so that Paul was self-employed the result is very different as the following example shows. This is primarily because the MIF already disincentives self-employed people from manipulating income to the extent shown in the DWP example.

We have used similar figures to the DWP paper, however we have included the increased net earnings due to the increase of the NMW, increased the disregard of £300 which was announced after the consultation and we have removed the work allowance.

The following table shows Barry and Paul, both employed and both earning the same net amount over 12 months. Barry receives the same earnings each month, Paul receives all of his earnings in just two payments. The figures show their UC payments under the current rules (before the Surplus earnings policy is applied). As this table shows, Paul receives significantly more UC than Barry.

MONTH	Barry's net earnings	Barry's UC payment[2]	Paul's net earnings	Paul's UC payment
1	1006.49	101.73	6038.94	0
2	1006.49	101.73	0	755.95
3	1006.49	101.73	0	755.95
4	1006.49	101.73	0	755.95
5	1006.49	101.73	0	755.95
6	1006.49	101.73	0	755.95
7	1006.49	101.73	6038.94	0
8	1006.49	101.73	0	755.95
9	1006.49	101.73	0	755.95
10	1006.49	101.73	0	755.95
11	1006.49	101.73	0	755.95
12	1006.49	101.73	0	755.95

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364573/uc-earnings-Explanatory_Memorandum.pdf

[2] This UC payment is calculated based on maximum UC of 755.95 which was calculated based on the figures used in the DWP paper showing a NIL UC point of 1163. 755.95 x 100/65 = 1163

TOTAL	12,077.88	1220.76	12,077.88	7559.50

The following table shows what Paul would receive if he were self-employed rather than employed. This shows that actually Paul would be worse off than his employed counterpart Barry and therefore, under the existing rules, the same manipulation is not possible if Paul is self-employed rather than employed. This is due to the impact of the MIF.

MONTH	**Paul's actual earnings**	**Paul's earnings used in the UC calculation**	**Paul's UC payment**
1	6038.94	6038.94	0
2	0	1006.49	101.73
3	0	1006.49	101.73
4	0	1006.49	101.73
5	0	1006.49	101.73
6	0	1006.49	101.73
7	6038.94	6038.94	0
8	0	1006.49	101.73
9	0	1006.49	101.73
10	0	1006.49	101.73
11	0	1006.49	101.73
12	0	1006.49	101.73
TOTAL	12,077.88	22,142.78	1017.30

This second table shows the operation of the surplus earnings policy on self-employed Paul. It shows that Paul would lose over £600 of UC compared to his position under the existing rules and would be over £800 worse off than Barry.[1]

MONTH	**Paul's actual earnings**	**Paul's surplus amounts**	**Amount treated as earned income if he claims UC in each month**	**Paul's UC payment**
1	6038.94	4575.94	6038.94	0
2	0	3112.94	4575.94	0
3	0	1649.94	3112.94	0
4	0	186.94	1649.94	0
5	0	0	1006.49	101.73
6	0	0	1006.49	101.73
7	6038.94	4575.94	6038.94	0

[1] The Regulations (SI 345/2015) as originally enacted are not entirely clear about how the MIF works when calculating the surplus amount. We have therefore not included the MIF as Paul's actual income when calculating his surplus amounts. If the MIF was to be included Paul would receive no UC in months 5,6,11 and 12.

8	0	3112.94	4575.94	0
9	0	1649.94	3112.94	0
10	0	186.94	1649.94	0
11	0	0	1006.49	101.73
12	0	0	1006.49	101.73
TOTAL	12,077.88			406.92

Example 3 – Alyssa

MONTH	Actual self-employed earnings (annual insurance premum paid Month 5)[1]	Earned income for UC purposes [2]	Monthly UC payment[3]	Actual self-employed earnings (monthly insurance premium)[4]	Monthly UC payment[5]
1	1,200	1,200	1078.05	1,100	1143.05
2	1,250	1,250	1045.55	1,150	1110.55
3	1,250	1,250	1045.55	1,150	1110.55
4	1,275	1,275	1029.30	1,175	1094.30
5	100	1,006.49	1203.84	1,200	1078.05
6	1,300	1,300	1013.05	1,200	1078.05
7	1,200	1,200	1078.05	1,100	1143.05
8	1,250	1,250	1045.55	1,150	1110.55
9	1,200	1,200	1078.05	1,100	1143.05
10	1,300	1,300	1013.05	1,200	1078.05
11	1,200	1,200	1078.05	1,100	1143.05
12	1,225	1,225	1061.80	1,125	1126.80
TOTAL	13,750	14,656.49	12769.89	13,750	13359.10

[1] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium of £1,200 is paid in Month 5.
[2] The MIF is applied in Month 5 because earned income is below £1,006.49 – the level of the MIF.
[3] For the purposes of the calculation we have assumed that Alyssa's maximum UC amount is £1,600 due to children, housing costs and childcare costs. Her work allowance is £397.
[4] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium is paid £100 a month for 12 months.
[5] Again we have assumed that the maximum UC amount is £1,600.