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Public Sector Reform of Intermediaries Legislation (IR35)

Background – what is IR35?

Intermediaries Legislation, or IR35, became law in April 2000. It was intended to tackle concerns about businesses hiring individuals as consultants rather than employees. The particular example given was someone leaving work as an employee on a Friday, only to return the following Monday to do exactly the same job as a consultant. In this scenario the business reduces their statutory responsibilities (as employment law is no longer applicable), whilst also reducing their employer NIC bill. The individual loses their statutory rights but gains flexibility and further tax planning benefits.

The premise of IR35 is that any individual caught by the legislation (also known as being "inside IR35") must pay tax and NICs on a deemed payment broadly equivalent to the tax and NIC that an employee would pay.

IR35 legislation requires evidence to be considered covering several factors, with the actual working practices being more important than the contractual agreement. Considerations include, but are not limited to:

- **Control** – to what extent the individual is told *how* to undertake the work
- **Substitution** – whether the individual can send someone else to deliver the same outcome
- **Mutuality of obligation** – for the hirer to provide work and the individual complete it
- **Financial risk** – whether the individual is on business on their own account
- **Part & parcel of the hiring firm** – the extent to which the individual is treated as an employee

All of the evidence is considered, an overview taken, and if the balance of probabilities is that the worker is more akin to an employee than being in business in their own right then IR35 applies. The individual is assessed to be inside, or caught by, IR35 and must pay tax and NIC to HMRC based on the income for that assignment.

Alongside IR35 legislation there is **16 years of case law** which informs the IR35 status outcome.

The legislation originally intended for the hiring business to be responsible for IR35 status of anyone that they engage, but there was concern that it would disrupt the flexible workforce – see below quote from the then Paymaster General. As they are in business on their own account, IR35 liability has always been the responsibility of the individual being engaged to carry out their services to the hiring firm.

> "I am determined that nobody should be able to avoid paying their fair share of tax and NICs just because of the way that they structure their relationship. But we have recognised that any action must do no unnecessary damage to the flexible labour market."
>
> Dawn Primarolo, Paymaster General, September 1999

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What changes are coming in?

- **Effective from 6 April 2017**
- **Public sector bodies** will be responsible for determining IR35 status.
- **Public sector bodies** must communicate their IR35 determination to the supply chain, i.e. the company that they contract with to supply the labour.
- **"Fee-payer"** is the entity contractually responsible for paying the intermediary (usually a personal service company) of the individual doing the work.
- **The Fee-payer** is legally responsible for ensuring correct tax and NICs are paid when paying the individual contractor's personal service company.

There are no official plans to extend the changes beyond the public sector, although it is widely anticipated to be rolled out to the private sector in due course. In the meantime, we will have a two tier system where the status of the hiring business dictates how an individual is engaged by it and ultimately what taxes are paid.

Unaffected by the changes:

- Unincorporated self-employed (sole-traders).
- Agency workers.
- Umbrella employees.
- Outsourced services where there is a break in the labour supply chain:
  - E.g. building a hospital where the required workforce is supplied to the privately owned construction firm and not to the public sector body.
  - but be careful and **seek legal advice** on the detail of the contractual supply chain.

Who are the public sector?

The legislation defines public sector as any organization caught by the Freedom of Information Acts (2000 England, and 2002 Scotland). This includes:

- NHS, police, fire, MoD, TfL
- Local authorities
- Devolved administrations
- Education
- BBC, Channel 4
- Bank of England

The definition also includes any organisation that is wholly owned by a public sector body. Clients ought to know if they are caught by the FOI Act definition. It is worth noting that FOI Acts can be varied so should be monitored for any changes.

Liability in more detail: public sector hirers

- Hirers are required to communicate their IR35 determination to the agency closest to them in the supply chain **either before the contract is agreed, or when the services start** (whichever is the latest).
- For contracts entered into before 6 April 2017 the information must be provided on or before the first payment is made under the contract on or after 6 April 2017.
- The agency can raise written questions regarding the hirer's decision, and the hirer has 31 days to respond to these in writing.
- The hirer must take reasonable care in determining IR35 status.
- If the hirer fails in the above duties they become the fee-payer with the obligation to operate PAYE and NIC for engagements inside IR35.

Liability in more detail: fee-payers

- The fee-payer is liable for processing PAYE and NICs for contractors where the assignment is deemed inside IR35.
- The fee-payer will be required to pay any other employment costs, e.g. the apprenticeship levy which is due on payrolls in excess of £3m.
- The fee-payer might be several stages further down the supply chain from the hirer, so the IR35 status needs to be communicated throughout (although there is no obligation).
- There is no guidance on how the fee-payer should pay contractors while they await the IR35 determination from the hirer. It would be prudent to process via RTI payroll.
- If hirers incorrectly determine a contractor outside of IR35, there will be unpaid tax and NI which the fee-payer might be liable for.
  - (NB: the fee-payer could be the hirer if they fail to meet their duties as explained above.)
- If you are the fee-payer and you disagree with the hirer's IR35 determination this should be discussed as you could be liable for unpaid tax and NICs.
- **All assignments where payment is made on or after 6 April 2017 will be affected.**

Liability in more detail: contractors

- Contractors are required to notify the fee-payer whether their intermediary (personal service company) meets the conditions of liability for IR35 to apply.
  - E.g. whether the individual owns more than 5% of their personal service company.
- If contractors don't inform the fee-payer, conditions of liability will be assumed to be met and the fee-payer will need to operate PAYE and NICs if the engagement is within IR35.
- There is no transfer of liability to the contractor, however it is in their interest to share information otherwise they risk unnecessary PAYE and NICs being processed.

Tax deductible expenses

We are disappointed that the final legislation includes a confusing provision making it optional for fee-payers to consider deductible expenses when processing the deemed payment. It seems likely that fee-payers will look to exercise their option not to consider deductible expenses, leaving contractors to undertake this themselves via self-assessment, effectively penalising them by delaying receipt of properly incurred tax relief.

How will the payment be processed?

Currently IR35 deemed payments are calculated and paid annually as part of the contractor's usual business accounts for their personal service company. The proposed reforms will introduce additional complexity for the fee-payer firm to process the payment:

- The contractor issues their invoice at the agreed rate for the work undertaken.
- The fee-payer will pay the VAT element through their accounts payable.
- Consider whether any tax-deductible expenses are applicable (optional).
- The remaining invoice balance goes to payroll to be dealt with as gross pay.
    - From which PAYE and employee NICs needs to be deducted.
    - Employers NIC will be <u>an additional cost</u> to be paid (not deducted from the invoice).
    - Payroll will need to collect personal data and issue payslips, P45s, P60s etc.
- Payments and reconciliations need to be undertaken by different departments (accounts payable and payroll) in order to pay the invoice.
- **Employers NICs must be factored in somewhere within the supply chain costs.**
    - Legally these cannot be automatically deducted from the assignment rate, instead a new rate must be agreed.
- Other payroll costs such as the Apprenticeship Levy should also be planned for.

Financial complexities for contractors:

- Processing deemed payments throughout the year will mean paying tax much earlier than the corporate cycle which allows up to 9 months after the tax year ends.
- Deemed payment calculations made throughout the year will be inaccurate as there is no opportunity to take account of capital expenditure, pensions contributions etc.
- Therefore, in addition to the payments made throughout the year, the contractor will still need to process an annual calculation to reconcile their true position.
- There will need to be a mechanism to prevent this income being subject to corporation tax at the end of the financial year, as it has already been taxed once as earnings.
- Similarly, there will also need to be a mechanism to prevent double taxation when withdrawing the funds from the personal service company as either salary or dividends.

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Employment Status Service (ESS)

- HMRC have developed an online tool to support hirers in determining the IR35 status
    - https://www.gov.uk/guidance/check-employment-status-for-tax
- Using HMRC's Employment Status Service is not obligatory although they will guarantee the outcome generated by their service providing correct information is inputted.
- There are 5 sections covering: personal service, control, financial risk, business structure and whether someone is "part & parcel" of the hiring business.
- If a determination is clear from answers given to early questions, then it might not be necessary to complete all 5 sections of the ESS.
- The ESS has a "save & retrieve" function enabling information to be added over 7-days
- The ESS does not retain records beyond the 7-day save & retrieve function.
- There is a "print & sign" function enabling users to retain a copy of the determination and answers supplied to generate that outcome. **It is highly recommend that you do this.**
- There is no appeals process to dispute the determination generated by the ESS.

What are the options?

- Determine likely IR35 status in advance of filling roles:
    - Work out the cost implications of both scenarios (inside and outside IR35), and consider the impact on assignment rates.
    - Pay contractors through their personal service companies, either payroll or gross depending on final IR35 determination.

- Consider an employed solution such as a fixed term contract with hirer, or umbrella:
    - Ensure the impact of any additional costs are factored in somewhere.
    - It is essential to ensure the contractor has clarity regarding their gross pay rate.

- Consider an intermediary to process payments:
    - The final legislation (published 20/03/17) includes an MSC legislation carve out
    - Therefore the payment intermediary can be the same accountancy firm that advises the personal service company, **but care is needed.**
        - This is only applicable when PAYE and NICs are operated.
        - In this instance the intermediary does not become an MSC provider.
        - As it is outside the scope of MSC legislation, there is no debt transfer risk.
        - Should the intermediary process gross payments to the personal service company, MSC is not automatically dis-applied and needs to be considered.
        - **It is essential to obtain professional advice for your specific circumstances**.

- Agency payroll; again ensure any additional costs incurred (such as employers NICs and the apprenticeship levy) are properly considered and factored in.