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# HMRC's Crackdown on Contractors:

Government publishes draft legislation reforming IR35 rules in the private sector





# Government publishes draft legislation reforming IR35 rules in the private sector

In the recent draft Finance Bill published on 11 July, the Government has confirmed that the proposed changes to the off-payroll working rules (commonly known as "IR35" or the "intermediaries legislation") will go ahead. These represent a significant shift in the tax and compliance landscape for businesses that engage contractors through personal service companies ("PSCs"). Broadly, the changes mean that the reforms introduced in 2017 for the public sector will now apply for large and medium-sized enterprises in the private sector – so that the burden of tax and compliance is shifted from the PSC / off-payroll worker to the fee-payer or end-user client organisation. There are further important changes to the rules which apply to the public and private sector alike.

This briefing note provides both an overview of the IR35 reforms as set out in the draft legislation and sets out some practical guidance for affected businesses.

# Background

Broadly, the IR35 rules catch arrangements where the following three conditions are satisfied:

- an individual personally performs services for a client;
- the services are provided not under a contract between the individual and the client but rather between the client and a third party (typically a PSC, though this can include other entities); and
- if the services were provided under a contract between the client and the individual, the individual would be regarded as an employee for tax purposes.

The rules are basically designed to catch disguised employment relationships through PSCs. The key point of contention is often the third condition – i.e. whether the worker would be treated as an employee for tax purposes. There have been a number of cases before the tax tribunals in recent years focussing on this particular point. It is not

explored further in this briefing – save to note that it requires a detailed examination of both the relevant contractual arrangements and the actual working practices of the worker.

If IR35 applies, the worker is deemed to be in receipt of a payment of earnings, with a consequent obligation to account for income tax through PAYE and NICs. Historically, the PAYE obligation fell on the PSC for all engagements within the scope of IR35.

However, in 2017, the rules were amended for engagements where the end-user / client was a public authority (primarily public authorities subject to the Freedom of Information Act 2000). For such engagements, it was the responsibility of the client public authority to determine whether IR35 applied, and the PAYE/NICs liability was shifted to the “fee-payer” (i.e. the entity paying the PSC) – which could be the client, or, in a more complex labour supply chain, the agency procuring the services of the worker.

# The Finance Bill 2019-20 changes

Following a lengthy consultation process, Finance Bill 2019-20 includes draft legislation rolling out the public sector changes to the private sector. The changes apply broadly for the tax year 2020-21 onwards, regardless of whether the contractor relationship was originally entered into before or after that date.

## Who is affected?

The changes only apply where the client is not "small". HMRC say this means they will not affect the vast majority of organisations who engage contractors through PSCs. For companies, "small" is determined in the same way as for the Companies Act 2006: i.e. currently where 2 or more of the following conditions are satisfied:

- the annual turnover is not more than £10.2 million;
- the balance sheet total is not more than £5.1 million; and
- the number of employees is not more than 50.

## How do the new rules work?

The basic purpose of the new rules is to align the treatment for medium and large private sector organisations with that of the public sector. However, further changes have been made, which apply to public sector and private sector arrangements alike.

The first step is to identify the chain of two or more persons involving the client at one end and the PSC at the other, where each person in the chain makes a payment to the next person which represents payment for the worker's services.

If the IR35 rules apply, then the **fee-payer** (i.e. the person

making the payment to the PSC) is treated as making a payment of earnings to the worker, and consequently is required to operate PAYE.

There are further detailed provisions for determining "small" in the context of joint ventures, subsidiaries, limited liability partnerships, unregistered companies, overseas companies and other persons.

The upshot is that where the (private sector) client is "small", the old rules still apply – i.e. the responsibility for determining whether IR35 applies and any consequent tax liability remains with the PSC (or other relevant intermediary). However, where the private sector client is medium or large, the burden switches to the end client and/or the fee-payer (if different).

So, in the most simple scenario, the chain involves an end-user client contracting directly with a PSC (and paying it direct), in which case the client is required to determine the IR35 status and operate PAYE. If the chain is more complex (i.e. involving one or more labour or recruitment agencies between the client and the PSC), then the client is still required to determine the IR35 status, although the PAYE obligation falls on the agency that actually pays the worker.

# Status determination statement

The new rules introduce the concept of a "status determination statement" or "SDS". This will be a key compliance issue for client organisations, and applies equally to public sector and medium/large private sector arrangements.

The SDS is a statement to be given by the client, which in practice will be required in respect of every engagement potentially within scope of IR35. It must contain two main things: (i) the client's conclusions as to whether the employment status limb of IR35 is met (i.e. whether the individual would be regarded as an employee for tax purposes if his/her services were provided directly under a contract between him/her and the client); and (ii) the reasons for that conclusion.

The rules effectively contain an explicit requirement for the client to take reasonable care in coming to the conclusion in an SDS (as if they fail to do so, the client is treated as not having made an SDS, with the negative consequences outlined below). It seems likely that this provision has been

included at least in part in response to concerns raised during the consultation process that organisations would simply impose blanket IR35 status determinations on all of their contractors performing similar roles. In the consultation response document, HMRC have stated that they will set out in guidance how a client can fulfil this obligation.

HMRC are also promoting their Check Employment Status for Tax (CEST) services as a tool for making status determinations. HMRC state generally that they will stand by the result given by CEST unless it becomes apparent that the information provided is inaccurate. This is helpful in theory, but many of the consultation respondents expressed concerns that the current version "did not accurately reflect current case law, used language which was overly complex, and was ambiguous about how it reached its decisions." HMRC say they are working to enhance the CEST service and that such enhancements will be tested with stakeholders and rolled out ahead of the introduction of the reforms. It remains to be seen how much of an impact any such enhancements will have in practice.

## What does a client do with the status determination statement?

Once the client has made its SDS, it must pass this on to **both** the next person in the chain **and** also to the worker. If everything works correctly, the intention is for the SDS to cascade its way down the labour supply chain until it reaches the fee-payer (whose responsibility it is to operate PAYE).

There is no set timing for doing this, but if a client fails to give an SDS to the worker, then the PAYE obligation falls on the client until this is rectified. In practice, we suspect this will be done before the relevant arrangement starts (for new engagements).

If the SDS is given by the client but not passed down the chain, then the PAYE liability sits with the party at fault. There are further provisions transferring that liability in the event

of non-payment. If HMRC cannot collect the PAYE from the defaulting party, then the liability transfers back to the first agency in the chain (i.e. the person one down from the client). If that party also fails to pay, the liability transfers to the client.

In the consultation response document, HMRC are explicit that the purpose of these transfer of liability provisions is to drive up compliance within labour supply chains. The first agency and the client are considered to be the parties who are best placed to influence and improve compliance within the whole chain. HMRC have also stated that they will make clear in guidance the circumstances in which they will not seek unpaid liabilities from parties further up the chain. They will also advise organisations on steps they can take to help ensure due diligence of their internal processes.

# Client-led disagreement process

The new rules also introduce a client-led disagreement process.

This gives a worker (or the fee-payer required to operate PAYE) the right to make representations to the client that the conclusion in an SDS is incorrect. The client then has 45 days to consider the representations and communicate its conclusion (together with reasons, if it does not change its mind). If the client does not do this, then it becomes liable for PAYE/NICs. HMRC are going to set out in guidance how they consider clients might implement the status disagreement process.

This is presented as a protection for workers against blanket status determinations, which it is to an extent. However, the obligation on the client remains fairly light. Clients are only required to consider representations and give their conclusions, plus reasons. So if a worker continues to disagree with the client's re-considered status determination, it has no further recourse or mechanism to challenge under the IR35 rules.

Of course the correct status under IR35 is a matter of fact and law, so a determination by a client is not binding on HMRC. A worker may therefore have additional avenues of challenge. In certain circumstances a PSC may have a contractual claim against a client (or fee-payer) on the basis that it has wrongly withheld amounts that were due to it. There may however be a number of difficulties in practice with such a claim (not least if there is an ongoing relationship).

An individual may also be able to take up the point with HMRC through his or her own self-assessment process – in which case the client may find itself drawn into the matter. This has the potential to give rise to a significant number of disputes in future – which does not seem to have been addressed to date in the relevant consultation and other materials.

Finally, HMRC have been at pains to stress that the reform is not retrospective, stating that they



**will not carry out targeted campaigns into previous years when individuals start paying employment taxes under IR35 for the first time. Organisations' decisions about whether workers are within the rules will not automatically trigger an enquiry into earlier years.**

On one view, this is quite a narrow assurance. And while the situation in one tax year is not strictly relevant to that in a previous year, it would be surprising if HMRC ignored entirely a client's status determination when deciding whether to raise an enquiry or issue an assessment for a historic period (even if that decision is taken on a case-by-case basis rather than under a targeted campaign or triggered automatically).

# Summary of new rules

In summary, the new rules represent a major change – and potentially a major compliance issue – for medium and large private sector organisations that engage individuals through PSCs. Previously, such organisations had been able simply to pay amounts gross for work done by such contractors, safe in the knowledge that any PAYE risk sat with someone else. However, that is no longer possible. Businesses will need to give proper consideration to the employment status of all PSC contractors, both existing and new, and will need to update their systems and processes accordingly. They should bear in mind that HMRC see the new rules as being a key tool for correcting compliance failures and are anticipating a significant increase in tax take as a result.



# What should affected businesses be doing to prepare for the changes?

Affected business should start preparing as soon as possible for the upcoming changes. HMRC have been clear that they expect preparations to begin well in advance of the April 2020 start date. They are likely to focus on reviewing compliance once the new rules take effect (and may have little sympathy if work has not been done in time).

Set out below is a (non-exhaustive) list of steps affected businesses might consider taking by way of preparation. There is no "one size fits all" approach here though. Each affected business should consider carefully the steps that are appropriate to it, depending on various factors, such as the size of its contractor workforce and commercial priorities.

- To the extent this has not been done already, consider forming a cross-functional IR35 project team (across the various relevant functions, e.g. HR, legal, finance, tax and procurement) to manage the upcoming changes and work towards implementation.
- As soon as possible, undertake a full audit of the status of existing contractors whose contracts extend beyond the April 2020 start date. The first step is to identify those contractors who contract through PSCs (or other intermediary entities). The status should be reviewed by reference to both the relevant contractual terms and the actual working practices of each contractor.
- As a result of this review, businesses may find that some contractors are clearly caught by IR35, while others are clearly not. For those that are caught, consider whether the simplest thing is to bring them onto payroll (though consideration should also be given to any employment law consequences). A number of contractors may be of more uncertain status – in which case, consider whether genuine changes to working practices might be able to take them more clearly outside of IR35.
- Once the audit exercise has been carried out, businesses will also need to manage how the results are communicated to contractors. Individuals may understandably be worried about this, as switching to PAYE could reduce their take-home pay significantly. It is important to be transparent and ensure that the contractors are fully informed and understand how seriously the reforms are being taken. Businesses should show that they are considering each individual case on its merits and not just imposing blanket determinations on similar groups of people.
- It is inevitable however that some contractors may disagree with status determinations. Put in place a process for dealing with this.
- It may also be advisable to audit current engagements with intermediaries and agencies that are used for the supply of workers. Businesses will need to be confident that each party in the supply chain has robust procedures and processes in place.
- Undertake an assessment of the financial impact of the new rules and increase budgets appropriately.
- Going forward, review current HR, procurement and other processes and procedures for onboarding contractors, in particular to build into that an assessment of the IR35 status.
- As part of this exercise, review standard form contracts and consider whether any changes are required. It may be necessary to implement a formal dispute resolution procedure (perhaps with named people in the business being responsible).
- Build into all engagements a process for review of the IR35 status at particular intervals. Given that IR35 status can depend so heavily on what actually happens in practice, as a contractor relationship develops over time, the real position may be different from that envisaged at the outset.
- Finally, it will be important to keep up-to-date with the draft legislation as it progresses. As noted above, HMRC have stated they will be providing detailed guidance on a number of practical issues, so affected businesses should watch out for this.

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